HOLMES
FEDERAL INCOME AND PROFITS TAXES

1921
SUPPLEMENT

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TO

FEDERAL INCOME TAX

War-Profits and Excess-Profits Taxes

INCLUDING

Stamp Taxes and Capital Stock Tax

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PREFACE

During 1920 many amendments and additions to Regulations 45 have been made; Regulations 55, on the stamp taxes, and Regulations 50, on the capital stock tax, have been revised; numerous rulings on specific questions arising under the income and excess-profits tax laws have been issued by the Treasury Department in the weekly "Treasury Bulletins," and the courts have rendered a number of important decisions under the various Revenue Acts. This new material has made necessary the publication of a supplement to the 1920 edition of Holmes Federal Income and Profits Taxes. The recent rulings, regulations and court decisions are set forth in this supplement, reference being made to the pages of the 1920 edition where may be found statements on the same subjects. The chapter on the War-Profits and Excess-Profits Tax has been completely revised and rewritten.

The thanks of the author are again extended to Mr. Randolph E. Paul, of the New York and New Jersey Bars, and Mr. H. B. Spaulding for their assistance in the preparation of the manuscript.

It is believed that the comprehensive index to the authorities cited, including all rulings appearing in the Treasury Bulletins, will be found helpful.

January, 1921. GEORGE E. HOLMES.

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LIST OF ABBREVIATIONS

T. D.	Treasury decision.
Op. A. G.	Opinion of Attorney General.
O. or L. O.	Solicitor's law opinion.
Sol. Op.	Solicitor's opinion.
S.	Solicitor's memorandum.
T. B. R.	Advisory Tax Board recommendation.
T. B. M.	Advisory Tax Board memorandum.
A. R. R.	Committee on Appeals and Review recommendation.
A. R. M.	Committee on Appeals and Review memorandum.
O. D.	Office decision.
I. T. S.	Corporation Trust Company Income Tax Service.
W. T. S.	Corporation Trust Company War Tax Service.

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CHAPTER 2.

THE INCOME TAX RATES

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LIMITATION IN CASE OF SALES OF MINES, OIL OR GAS WELLS. Where individuals transfer property to a corporation which later demonstrates the principal value of such property as oil-producing property "by prospecting or exploration and discovery work" and then dissolves, transferring the property to the individuals, who had remained stockholders without change in interests, and such stockholders sell the property, the portion of the surtax attributable to such sale is not limited to 20% of the selling price of such property or interests.[1] The limitation provided in the Revenue Act of 1918, with respect to the tax attributable to the sale of mines, oil or gas wells, or any interest therein has no application to the tax on profits realized from the sale of oil and gas produced in the operation of such wells.[2]

[1] T. B. R. 8, Treasury Bulletin 3-19-176.

[2] O. D. 658, Treasury Bulletin 37-20-1190.

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Surtax on Stockholders in Respect of Undistributed Profits of Corporations. This provision applies only to the income of 1918 and subsequent years and cannot be utilized to force a distribution of unnecessary surplus accumulated in prior years.[1]

[1] O. D. 188, Treasury Bulletin 8-19-326. To such unnecessary accumulations, however, the provisions of the Acts of October 3, 1913, September 8, 1916, and October 3, 1917, will be applicable according to the respective years in which such acts were in effect and such portions of the surplus were accumulated. The applicable provision of the Act of

September 8, 1916, is Section 3 and not Section 10 (b) added by the Revenue Act of 1917, which provided for a tax on the undistributed income of corporations without reference to whether such earnings were accumulated with a fraudulent purpose of preventing the imposition of the surtaxes.

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UNREASONABLE ACCUMULATION OF PROFITS. Whether a corporation is unreasonably accumulating its profits cannot be determined in advance; it must be determined at a later date in the light of what has actually been done with the profits retained.[1] The question is one of fact to be decided upon consideration of the volume of business done and the principles of sound business management.[2] A retirement of capital stock indicates that additional capital is not required by a corporation and if upon such a retirement surplus is permitted to stand, such surplus will be deemed an unreasonable accumulation.[3]

[1] T. B. M. 2, Treasury Bulletin 1-19-72.

[2] S. 1117, Treasury Bulletin 15-19-448. The fact that a corporation having a capital of $10,000 and doing an annual business in excess of $150,000, has an accumulation of $55,000 in undivided profits, is not sufficient basis for the finding that there has been an unreasonable accumulation of profits.

[3] O. D. 360, Treasury Bulletin 2-20-667.

CHAPTER 3.

INDIVIDUALS TO WHOM THE LAW IS APPLICABLE

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Footnote 3.

Add:—Maguire v. Trefry, U. S. Supreme Court, April 26, 1920, see 230 Mass. 503, 120 N. E. 162.

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WHO IS A CITIZEN. Under the naturalization laws of the United States, the naturalization of a father operates to confer the right of citizenship upon his minor child who is dwelling at the time of the father's naturalization within the jurisdiction of the United States or who dwells within that jurisdiction subsequent to the father's naturalization and during the child's minority. If after attaining his majority the son returns to his native land, but registers with the American Consul under the rules and regulations prescribed by the Department of State as an American citizen residing abroad, his status under American law is that of an American citizen.[1]

[1] O. D. 695, Treasury Bulletin 43-20-1256.

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CITIZENS RESIDING ABROAD. Income received by a citizen of the United States residing abroad from foreign sources in foreign money or credits should be reported in terms of United States money on the basis of the rate of exchange in effect at the time it was actually received.[1]

[1] O. D. 459, Treasury Bulletin 16-20-873. For the rates of exchange prevailing on December 31, 1919, see O. D. 551, Treasury Bulletin 25-20-1010.

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Aliens Residing in the United States. Where a nonresident alien taxpayer becomes a citizen or resident of the United States during the taxable year, he is taxable for the entire

year upon income derived from all sources.[1] The payrolls of an employer may be accepted as written evidence of an employee's continuous residence in the United States thereby establishing his status as a resident alien unless the employer knows that the employee does not intend to remain here permanently.[2]

[1] O. 785, Treasury Bulletin 1-19-66.

[2] O. D. 127, Treasury Bulletin 3-19-195.

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WHO ARE RESIDENT ALIENS. A British citizen, a member of a British partnership, who is within the territorial limits of the United States seven or eight months of the year for the purpose of transacting business for the partnership and who returns to Europe when the purpose which necessitates his presence in the United States is accomplished is considered a non-resident alien.[1] The fact that Germans who were resident aliens of the United States prior to the war with Germany were registered as alien enemies will not deprive them of their status as residents for income-tax purposes if the conduct, acts, and declarations of the aliens indicate their intention to maintain their status as residents.[2] The Treasury Department holds that residence in the United States by an alien for as much as one year establishes a presumption that such alien is a resident of the United States and this presumption will be indulged for purposes of income tax in the absence of known facts showing that the alien is in fact a transient.[3]

[1] O. D. 592, Treasury Bulletin 29-20-1072.

[2] O. D. 400, Treasury Bulletin 6-20-731.

[3] O. D. 197, Treasury Bulletin 9-19-342.

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Footnote 36.

Add:—O. D. 333, Treasury Bulletin 28-19-619.

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"COMMUNITY" PROPERTY AND INCOME OF HUSBAND AND WIFE. What is known as the "community property system" prevails in Texas, Arizona, California, Washington, Louisiana and New Mexico. It seems to have had its origin in France and Spain and to have been brought thence into the judicial

systems of the above States. Community property laws provide generally that all property acquired during marriage by the industry and labor of either husband or wife, or both together, with the produce and increase thereof, belongs to both in equal shares during the continuance of the marital relation.[1] The foundation of this community property system lies in the fact or the legal assumption that all property acquired during marriage otherwise than by gift, devise or descent, is acquired by the joint efforts of husband and wife.[2] Their relation partakes of the nature of a partnership in which each partner may have separate assets or property as well as common stock of acquisitions and gains. The business of the firm generally is transacted in the name of the husband and he prosecutes and defends its suits with the same effect as if his partner were named in the case;[3] and although community property has not all the incidents of partnership property, it has many of them and is commonly spoken of as partnership property.[4] In a conventional partnership the gains of the partners are in proportion to their respective shares of stock and services, but in the conjugal partnership implied in the community property system, the division is equal although one spouse may have brought in the greater part if not all of the property from which the profits are derived or may have contributed all his or her skill and services unaided by the other.[5]

[1] See Tucker v. Carr, 39 Tex. 98; Cooks v. Bremond, 27 Tex. 457; Fennell v. Drinkhouse, 131 Cal. 447, 63 Pac. 734; Washburn v. Washburn, 9 Cal. 475; Succession v. Webre, 49 La. Ann. 1491, 22 So. 390; Knight v. Kaufman, 105 La. 35, 29 So. 711; Manning v. Burke, 107 La. 456, 31 So. 862; Abbott v. Wetherby, 6 Wash. 507 33 Pac. 1070; Yake v. Pugh, 13 Wash. 78, 42 Pac. 528; Sherlock v. Denny, 28 Wash. 170, 68 Pac. 452; Cline v. Hackbarth, 27 Tex. Civ. App. 391, 65 S. W. 1086; Johnson v. Burford, 39 Tex. 242; Pearce v. Jackson, 61 Tex. 642.

[2] Nickerson v. Nickerson, 65 Tex. 281.

[3] Simpson v. Brotherton, 62 Tex. 170.

[4] De Blanc v. Lynch & Co., 23 Tex. 25; Wilkinson v. Wilkinson, 20 Tex. 237; Holyoke v. Jackson (Wash.), 3 Pac. 841.

[5] Wheat v. Owens, 15 Tex. 241; Routh v. Routh, 57 Tex. 589; Merrell v. Moore, 47 Tex. Civ. App. 200, 104 S. W. 514; Edwards v. Brown, 68 Tex. 329; Saunders v. Isbell, 5 Tex. Civ. App. 513, 24 S. W. 307; Barr v. Simpson, 54 Tex. Civ. App. 105, 117 S. W. 1041; Wright v. Hays' Admr., 10 Tex. 130; Zimpelman v. Robb, 53 Tex. 274; T. D. 2450.

The fact that one or the other of the spouses may do all the work does not change the character of community property[6] and though the management and disposal of community property during marriage are usually given to the husband, this is said to be for reasons of public policy and social economy and not on the ground that the husband has any greater interest in it than the wife. It is provided[7] in Texas that the personal earnings of the wife, the rents from her estate, the interest on bonds and notes belonging to her and dividends on stocks owned by her shall be under the control, management and disposition of the wife alone; but the Supreme Court has held that this provision did not change the character of rents from the wife's separate property so as to make them her separate property but that they continue to belong to the community estate and the husband was the owner of one-half of the same.[8] Under the laws of the various States wherein the community property system obtains, the earnings of *separate* property of the spouses, with such exceptions as are specifically provided for by statute, are community property.[9] Under the law of Texas it has been held that:

(1) The earnings of husband and wife belong to them jointly in equal shares.

(2) The community interest attaches as soon as the right to the wage comes into existence.

(3) The increase and revenues from the *separate* property of each spouse (except the increase, rents and revenues from lands) is also community property in which the interests of husband and wife are equal.

It has, therefore, been ruled that:

(1) The *earnings* of husband and wife and the revenues from their *community property and separate personal property* are community income under the provisions of the Revenue Act of 1918.

[6] Yates v. Houston, 3 Tex. 433.

[7] See Section 4622 Vernon's Sayles' Statutes as amended in 1913.

[8] Tannehill v. Tannehill (Tex. Civ. App.), 171 S. W. 1050. This before the amendment of Section 4621 in 1917 made the rents from separate lands the separate property of the owner of the land.

[9] Barr v. Simpson, 54 Tex. Civ. App. 105. 117 S. W. 1040; Hayden v. McMillan, 4 Tex. Civ. App. 479, 23 S. W. 430.

(2) That the husband and wife in rendering separate income tax returns may each report as gross income one-half the total—

(a) Earnings of the husband and wife,

(b) Income from separate property, and

(c) Income from community property.[10]

[10] T. D. 3071, containing a copy of an opinion of the Attorney General to the Secretary of the Treasury, dated August 24, 1920, Treasury Bulletin 39-20-1218, modifying O. D. 285, Treasury Bulletin 21-19-528 and O. D. 426, Treasury Bulletin 13-20-815.

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ABATEMENT, CREDIT AND REFUND IN CASE OF COMMUNITY INCOME. The following procedure has been approved with regard to amended returns and claims for refund, credit, or abatement under the ruling contained in the preceding paragraph with regard to community income under the laws of Texas, in so far as taxpayers in the State of Texas are concerned: The ruling in question is applicable to each and every year during which the law of the State contains the provisions giving the husband and wife equal right to community property and amended returns and claims may be filed for any such year, subject to the five-year limitation imposed by the Revenue Act of 1918.[1] In all cases in which the husband and wife desire to take advantage of the ruling for prior years, each will be required to file a separate return for the year or years involved, in which the net income is computed in accordance with the present ruling. In cases where an original return was filed by the husband and no return filed by the wife, the wife will be required to pay the tax shown to be due by the return now filed by her and the husband should apply for refund, credit, or abatement of the difference between the tax shown on the original return and the tax shown on the return now filed by him. In cases where an original return was filed by the wife and no return filed by the husband, the husband will be required to pay the tax shown to be due by the return now filed by him, and the wife should apply for refund, credit, or abatement of the difference between the tax shown on the original return and the tax shown on the return now filed by

[1] Revenue Act of 1918, § 252.

her. In cases where the husband and wife filed separate original returns, the individual now filing return showing additional tax liability will be required to pay such additional tax and the individual now filing return showing a reduced tax liability should apply for refund, credit, or abatement of the amount of tax now shown not to be due. Claim for refund, credit, or abatement must be filed by the individual shown to be entitled to such relief according to the returns filed, and the tax paid on a return filed in the name of the husband or of the wife will not be refunded or credited to any one except the individual in whose name the original return was filed. In all cases in which it appears that returns are filed as a result of the ruling contained in the preceding paragraph, and the income shown in the returns now filed was disclosed in a prior return or returns, penalty on account of delinquency will not be asserted and interest on account of failure to pay the tax shown by the returns on the date payment was required by law will not be collected.[2]

[2] O. D. 708, Treasury Bulletin 43-20-1270.

CHAPTER 4.

NON-RESIDENT ALIENS

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Who Is a Non-Resident Alien. The status of an alien leaving the United States during the taxable year is determined by his status on the last day of his taxable period. Such taxable period is the interval between January 1 and the last day of the month preceding his departure. If the alien had formed no intention of leaving the United States by such date he will be taxed as a resident alien. If, however, his intention to depart was formed prior to the last day of the month preceding departure, he will be taxed as a non-resident alien for such period. In either case the alien is entitled to the full exemption and credit for dependents that he would have been entitled to had his return been filed for the full taxable year. If the absence of a resident alien is to be only temporary, he will not lose his status as resident by reason of such absence.[1] An alien who established a residence in the United States in 1910 and subsequently acquired property interests in this country and who enlisted in the army of his native country in 1917, serving abroad until 1919, when he returned to the United States in accordance with an intention to do so expressed prior to his departure, will not be considered to have lost his status of resident alien and will be required to render returns as such, including in gross income the compensation received for services in the foreign army as well as his taxable income from all other sources.[2] A non-resident alien who has served in the United States army for a period of one year is considered a resident of the United States for income tax purposes.[3] The members of families of foreign ambassadors and ministers are considered non-resident aliens for income tax purposes.[4]

[1] O. D. 468, Treasury Bulletin 16-20-867.
[2] O. D. 498, Treasury Bulletin 19-20-921.
[3] O. D. 117, Treasury Bulletin 3-19-175.
[4] O. D. 198, Treasury Bulletin 9-19-343.

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Footnote 3.

Add:—See also O. D. 533, Treasury Bulletin 23-20-983 as to resumption of citizenship by widow of non-resident alien.

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RESIDENCE OF ALIEN SEAMAN. Since the term "United States" is defined in the Law to mean the States, the District of Columbia and the territories of Alaska and Hawaii, excluding other places, it has been held that vessels plying between the continental United States and Porto Rico are engaged in "foreign trade." A citizen and resident of Porto Rico employed as seaman aboard such a vessel and who has not established himself otherwise as a resident of the United States occupies the status of a non-resident alien for income tax purposes.[1] The term "foreign trade" includes the transportation upon the high seas of passengers and freight between the United States and foreign countries.[2]

[1] O. D. 536, Treasury Bulletin 23-20-987.

[2] O. D. 315, Treasury Bulletin 26-19-591.

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Footnote 9.

Add:—T. D. 2876.

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INTEREST. The interest on bonds and notes of foreign countries or non-resident foreign corporations owned by non-resident aliens is not subject to income tax in the hands of the recipients whether paid in the United States or abroad nor is a profit realized on foreign exchange from such payment taxable.[1] Where bonds, notes or other obligations of a foreign government are underwritten by a United States banking establishment and are by their terms payable at an office of such banking establishment in the United States, interest paid from the United States office to non-resident alien individuals or foreign corporations who are holders of such securities is not regarded as income from a source within the United

[1] O. D. 35, Treasury Bulletin 1-19-47; O. D. 239, Treasury Bulletin 13-19-417.

States.[2] It has been ruled that where a bank in the United States collects interest upon foreign securities for its non-resident alien customers and credits same to their account, allowing interest on the balance so maintained, the identity of the interest derived from foreign securities is lost and the interest thus paid or credited is subject to tax and withholding.[3] A corporation which was organized in the United States has its principal assets located in a foreign country. Its accounts were kept abroad until 1915 when its affairs were placed in the hands of receivers appointed by a United States court. Since that time, the receivers have conducted the business for the benefit of the bondholders on whose behalf they were appointed, but upon the liquidation of the over due interest upon its mortgages the corporation will be reinstated as an operating company. The corporation owns property in this country which it has pledged as part security for its mortgages. It maintains an office in the United States for convenience in making purchases of goods to be shipped to the country in which it operates. Its funds are on deposit in domestic banks and the receivers have an office in this country where they conduct the affairs of the corporation. It has been held that the company is not only a corporation organized under the laws of the United States but is also a resident of the United States actually and substantially carrying on business therein and that interest paid on its bonds to non-resident aliens is income from sources within the United States.[4]

[2] O. 786, Treasury Bulletin 1-19-16.
[3] O. D. 269, Treasury Bulletin 18-19-485.
[4] O. D. 517, Treasury Bulletin 21-20-955.

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INTEREST UPON OBLIGATIONS OF THE UNITED STATES. Where trustees hold United States Liberty bonds or Victory notes in trust for a non-resident alien life beneficiary and are to distribute the income periodically, the bonds and notes are held to be "beneficially owned" by such non-resident alien.[1]

[1] O. D. 464, Treasury Bulletin 16-20-861.

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Footnote 23.

Add:—The same rule applies to interest on tax-free covenant bonds of such corporations (O. 908, Treasury Bulletin 18-19-478).

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DISCOUNT. Where non-resident aliens purchase British Government treasury bills at a discount in United States markets and collect the same at maturity either in the foreign country or from the paying agent of that Government in the United States, such discount is not income from sources within the United States and is not subject to tax.[1]

[1] O. D. 534, Treasury Bulletin 23-20-985.

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SALARIES FOR EXTRA-TERRITORIAL SERVICES PAID BY RESIDENT EMPLOYERS. A non-resident alien individual employed by a domestic corporation on a monthly salary basis as its salesman in a foreign territory, who visits the home office of the company the first part of each year for the purpose of reporting on sales and conditions generally in the foreign markets and receiving instructions in sales methods and in regard to new apparatus, is held not subject to tax on the salary he receives while in the United States.[1]

[1] O. D. 578, Treasury Bulletin 28-20-1053.

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WAGES OF ALIEN SEAMEN. The wages earned by persons serving aboard vessels plying between the continental United States and Porto Rico do not constitute income from sources within the United States since such vessels are held to be engaged in foreign trade.[1] A steamer engaged in foreign trade which lies for a period of two weeks in a United States port for the purpose of completing repairs is deemed to be in such port a reasonable time for the transaction of business, and wages paid to its non-resident seamen during such period are income from sources without the United States.[2] Wages earned by a

[1] O. D. 536, Treasury Bulletin 23-20-987.

[2] O. D. 559, Treasury Bulletin 26-20-1027.

non-resident alien on an occasional coastwise voyage on a vessel generally making foreign voyages are income from sources within the United States.[3]

[3] O. D. 245, Treasury Bulletin 13-19-424.

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INCOME FROM THE SALE OF PROPERTY. An alien who comes to the United States with merchandise which he disposes of in this country is subject to tax on the profit derived from such activities even though he is within the United States for a period of less than 30 days.[1] Where non-resident aliens purchase British Government treasury bills at a discount in United States markets and sell the same at a profit in the United States such profit is income from sources within the United States and subject to tax.[2]

[1] O. D. 291, Treasury Bulletin 23-19-543.
[2] O. D. 534, Treasury Bulletin 23-20-985.

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Abatement and Refund. When a claim for refund is filed by aliens, resident or non-resident, on Form 46, a copy of the form upon which the alien was assessed and taxed should be attached to Form 46.[1]

[1] O. D. 272, Treasury Bulletin 18-19-488.

CHAPTER 5.

RESIDENT AGENTS FOR NON-RESIDENT ALIENS AND FOREIGN CORPORATIONS—NOMINAL STOCKHOLDERS

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Footnote 7.

Add:—Reg. 45, Art. 404. A resident fiduciary is not liable for surtax on the income which it received as trustee for a nonresident alien beneficiary, under the Revenue Act of 1917, provided the income was returned for the purpose of the tax by the beneficiary. (O. 1011, Treasury Bulletin 12-20-798.)

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Who Are Resident Agents. A domestic corporation purchased abroad from a foreign corporation goods at a minimum price for resale in the United States. If sold for more than the minimum price, the domestic corporation was to receive a commission and after deducting certain expenses and the commission, the net profit was divided between the domestic corporation and the foreign corporation. The share of the profits so received by the foreign corporation represents income from sources within the United States, but is not subject to the withholding provisions of the Revenue Act of 1918, since it is not "fixed or determinable income" within the meaning of the act. However, the domestic corporation acting as agent of the foreign corporation with respect to goods sold in the United States must file a return of income (Form 1120) for the foreign corporation and pay any tax found to be due.[1] An insurance broker in the United States who solicits and procures insurance in non-resident alien corporations, collects the premiums thereon, and credits the account of the respective corporations with the net proceeds after deductions for losses are made, is considered the resident agent of such foreign corporations with respect to the business obtained through his efforts. Where the insurance broker transacts business in the

[1] O. D. 384, Treasury Bulletin 4-20-708.

United States for certain non-resident foreign corporations and pays the premiums to a non-resident alien individual who acts as agent for the non-resident foreign corporations it has been held that the insurance broker must file returns for each non-resident foreign corporation, covering the gross income received from sources within the United States within the purview of his agency, claiming therein any deductions to which the corporations are entitled by reason of losses sustained and pay the total tax due thereon.[2]

[2] O. D. 586, Treasury Bulletin 28-20-1062.

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Procedure in Collecting Income for Non-Residents. The appointment by a non-resident alien banking corporation of a resident agent in the United States who has authority to make returns for the corporation will relieve a domestic bank from the responsibility of withholding the tax from the interest credited to the account of the foreign bank provided the agent furnishes a certificate stating that the foreign corporation has an office or place of business in the United States and that he will make all necessary returns and pay the taxes shown to be due.[1]

[1] O. D. 358, Treasury Bulletin 1-20-661.

CHAPTER 6.

FIDUCIARIES

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AGENTS. An oral agreement whereby one of a number of brothers and sisters acts as agent for all of them in managing property held by them as tenants in common under the father's will, and in distributing the income therefrom, is not a legal trust for income tax purposes, nor is the agent a fiduciary. Each principal should file a separate return, including therein his share of the income from the property and claiming a proportionate share of any allowable deductions.[1]

[1] O. D. 425, Treasury Bulletin 13-20-814.

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TRUSTEES IN BANKRUPTCY. A trustee in bankruptcy is a fiduciary and is required to file a return for the bankrupt estate if its net income exceeds the specific exemption of $1000.[1]

[1] O. D. 174, Treasury Bulletin 7-19-297.

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ALIEN PROPERTY CUSTODIAN. The Alien Property Custodian appointed by the President during the war, under the authority of the Trading with the Enemy Act, is not a fiduciary within the meaning of the Revenue Act of 1918, but is a mere official of the Government, or agent of the President in taking over and preserving the property of alien enemies. Insofar as the Alien Property Custodian is given authority under the Trading with the Enemy Act to receive moneys (as distinguished from property), he is obliged to pass such money on to the Treasury of the United States. The Alien Property Custodian is, therefore, not required to make return or pay taxes in behalf of alien enemies whose money or property is taken over by him. This does not mean that if income shall

have accrued during the period when the property has been held by the Alien Property Custodian the former alien enemy owners are not liable for income taxes. Before paying out any funds representing such income, the Treasury Department may ascertain the taxes due and require them to be paid.[1]

[1] Op. A. G. 2, Treasury Bulletin 30-20-1092.

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DEEDS OF TRUST. Where a person transfers funds or property to trustees to pay to him during his lifetime so much of the income as he may demand, and from time to time as much of the principal as such trustees might deem advisable, all unwithdrawn income at the date of the death of the settlor to become a part of the trust fund, the settlor should return in any one year all the income accruing from such trust fund whether actually withdrawn by him or not. The trustees under such deed must make return of all income from the trust, but are relieved from paying a tax thereon.[1] Where a declaration of trust provides that during the life of the donor he may indicate the manner in which the trustee shall exercise the powers conferred by the trust agreement; that the donor shall have a voice in determining the amount of net income to be distributed to the beneficiaries; and that the estate created and the interests vested thereunder shall be subject to revocation by the donor at any time, in whole or in part, it is held that the amount of income received by the beneficiaries is in the nature of a gift, and that the trustee merely acts as agent for the donor. The income of the trust should therefore be included in the gross income of the donor. The trustee should file a return for the trust on Form 1041, revised, showing the grantor as beneficiary under the trust and the grantor should include the net income of the trust in gross income in his individual return under the item of income from fiduciaries.[2]

[1] S. 1344, Treasury Bulletin 10-20-780; O. D. 621, Treasury Bulletin 32-20-1116.
[2] O. D. 676, Treasury Bulletin 40-20-1224.

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Income of Estates and Trusts. Where the same trustee is designated in a will to administer several trusts, the accumu-

lated income of each separate trust will be taxable as an entity, not the income of the trusts combined.[1]

[1] O. D. 316, Treasury Bulletin 26-19-592.

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Gross Income of Estates and Trusts. The corpus of an estate, that is, the amount of capital transferred to the estate at the time of its creation, is not income.[1] In general, this corpus may produce income in two ways: (1) By investment of the corpus producing income in the form of interest, rents, or other return on capital, and (2) by profit derived from a sale or exchange of the corpus. Both these forms of increase of the corpus of an estate constitute taxable income to the estate. Thus, amounts paid by an executor of an estate out of his personal funds in discharge of obligations of the estate, such amounts being credited against the executor's liability for interest to the estate, are nevertheless income to the estate to the extent that they represent interest accrued since the death of the testator on obligations of the executor to the estate.[2] If securities held in trust and forming the corpus of a trust estate are sold and the selling price exceeds their value at the time the trust is created, such excess constitutes taxable income to the estate, even though under the terms of the trust the income from the securities is payable to individual beneficiaries.[3] An executor who pays to another, as agent, a commission upon the sale of property belonging to the estate may deduct from the selling price the amount so paid in determining the gain or loss arising from the sale. An executor who retains as his commission a portion of the amount received by him from the sale of property belonging to the estate may not deduct the amount in preparing a return for the estate since any service performed by him in that connection is deemed to

[1] See page 75 of the 1920 edition. In the case of estates of deceased persons the appraised value of the property *at the time of death* (not the date of distribution of the assets) constitutes the corpus. In the case of estates created by trust instruments the value of the property constituting the subject of the trust at the time the trust is created constitutes the corpus (O. D. 1012, Treasury Bulletin 12-27-92).

[2] O. D. 51, Treasury Bulletin 1-19-70.

[3] O. D. 129, Treasury Bulletin 3-19-198.

be a part of his duties as executor. Such a commission, however, should be included in the gross income reported in the executor's personal return for the year in which received.[4] Where the trustee of assets of an oil company sells oil or gas wells and the principal value of the property has been demonstrated by prospecting or exploration or discovery work done by the trustee, the 20% limitation upon the surtax attributable to such sale is applicable.[5] Where a corporation in liquidation turned over its assets to the executor of an estate to which it was indebted and which owned all of its outstanding capital stock, any excess in the value of the assets so received over the indebtedness of the corporation to the estate plus the value of the stock at the time of the owner's death constitutes profit subject to both normal tax and surtax in the hands of the executor of the estate.[6]

[4] O. D. 632, Treasury Bulletin 33-20-1135.

[5] O. D. 194, Treasury Bulletin 9-19-337. See page 20 of the 1920 edition.

[6] A. R. R. 67, Treasury Bulletin 17-20-877.

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Footnote 29.

Add:—A loss can not be claimed in a return rendered for a decedent covering the taxable period to the date of his death where the cost of securities, or their fair market value as at March 1, 1913, if acquired prior thereto, is in excess of the value established by appraisal for the purposes of administering the estate, except in the case of a decedent who was a dealer in securities and regularly inventoried his securities and made his returns accordingly. The executor should not make returns of book gains or losses, either up to the date of death or on transfer of the property to the legatee or to a trustee under the will, or from one trustee to a succeeding trustee, the appraised value remaining as the basis for computing all subsequent realizations of losses or gains in cash. (O. D. 219, Treasury Bulletin 11-19-383.) No taxable income or deductible loss results from the passage of property to the executor or administrator on the death of the decedent, even though such property has appreciated or depreciated in value since the decedent acquired it. (O. D. 731, Treasury Bulletin 46-20-1306.)

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INCOME CONSTRUCTIVELY RECEIVED BY DECEDENT PRIOR TO DEATH. Interest accrued on bonds owned by an individual

at the date of his death should be included in the return filed for the decedent by the executor or administrator, if the books of the decedent were kept on an accrual basis; if the books were kept on the basis of actual receipts and disbursements, only the amount of interest on coupons falling due prior to decedent's death should be included. Interest accruing or falling due subsequent to the decedent's death should be reported in the return of the estate.[1]

[1] O. D. 454, Treasury Bulletin 15-20-851.

[Page 77.]

INSTALLMENT SALES OF REAL PROPERTY. Where an individual contracted in July, 1919, to sell her farm and the contract provided for a cash payment of $2500, with $8000 to be paid on March 1, 1920, at which time a deed was to be given and possession transferred, and the balance of consideration was represented by notes bearing 5% interest and secured by first and second mortgages, payable $2000 in 1930 and $3400 in 1935, and the owner of the property died on September 4, 1919, pending the execution of the notes and mortgages and leaving four children, who were equal beneficiaries under her will, it has been held that no portion of the initial payment of $2500 constituted income to the owner to be included in her gross income as reported for the period from January 1, 1919, to the date of death. If upon the carrying out of the terms of the contract the property should be transferred to the purchaser prior to the termination of the administration of the estate, the executor would be required to report as income in the estate's 1920 return the difference between the fair market value of the property at the date of death and the total price received for the property, the 5% notes being considered the equivalent of cash.[1] A clearer statement of the reason why this sum was not taxable to the decedent would seem to be that it constituted a partial return of capital and was less

[1] O. D. 631, Treasury Bulletin 33-20-1134. The theory of the Treasury Department in holding the $2,500 paid to decedent before her death not to constitute taxable income is that such sum "represents merely a deposit or earnest money to bind the contract, no sale of the property having actually taken place."

than the cost or the fair market value of the property on March 1, 1913, as the case may be.

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INCOME BEQUEATHED TO A GOVERNMENTAL AGENCY OF A STATE. Where executors under a will hold property specifically bequeathed to a university, State owned, controlled and operated in every sense, and conducted by officers appointed in accordance with the State Constitution, supported by State funds and all the property of which is vested in the State, and the other assets of the decedent's estate are sufficient to pay all debts, income received by the executors during the period of administration from such property is not taxable in the hands of the executors. The education of the citizens of a State, when conducted by the State or by its subdivisions or agencies, is considered to be one of the public governmental functions of the State.[1]

[1] S. 1374, Treasury Bulletin 18-20-896. This conclusion was strengthened by the fact that under the laws of the State in question title to the property specifically devised or bequeathed passed by will. The title to the stocks bequeathed, therefore, vested immediately upon the death of the testator in the State university and under such circumstances a tax directed against the income from such property would be a tax upon income from property the title to which has vested in a State university. The ruling was made under the 1916 law, as amended, but it would be equally applicable under the Revenue Act of 1918.

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ACCUMULATIONS FOR CHARITABLE PURPOSES. Where a testator by will bequeaths and devises his whole estate to his executors in trust to invest and keep invested and to pay annuities to certain beneficiaries, the corpus of the estate, together with accumulated income to be paid to a designated charity after the coming of age of one beneficiary and the death of the survivor of the others, it has been argued that the income of the trust estate is taxable, notwithstanding the fact that it ultimately goes to charity. This argument was based upon the theory that while the estate might be large and the income therefrom many times the sum required to meet the annuities, there was no legal certainty that anything

would go to the charity. The court held, on the contrary, that such income was exempt from tax on two grounds: (1) That one part of the income was exempt because of the exemption in favor of charity, and the other part because it was below the taxable limit, such parts taking in the whole income; (2) that the income was not the income of the estate but of the parties to whom it was given, the legal representatives of the testator being nothing more than the reservoir and conduit pipe through which the income reached the beneficiaries.[1] It has been held by the Treasury Department, on the other hand, that income from the corpus of an estate which at some uncertain date in the future will, together with the accumulation of income of a certain character, be paid over to exempt corporations is taxable in the hands of the trustee, there being no exemption in the law to trustees who are to hold income for future distribution to exempt corporations.[2] Where under the terms of a will or trust deed income is to be paid to or permanently set aside for a charitable or exempt organization, such income is not deductible by the estate or trust where the exempt organization has received its charter but has not been completely organized or has not begun to operate sufficiently to establish its exemption.[3] In another case recently arising a testator gave property to a trust company to be held in trust for his wife and daughter for the period of their lives, the income accruing to be divided equally between them. It was provided that upon the death of the wife she might appoint a certain portion of the estate by her will and a similar provision was made in the case of the daughter. The principal remaining at the termination of the trust was directed to be paid over to certain charitable and educational corporations. In case the corpus of the estate remaining upon the death of the life beneficiaries was not in excess of the amount which might be appointed by the life beneficiaries in their respective wills the charitable and educational corporations would receive no part thereof, since it would go to the persons designated by the wife and daughter under the power of appointment given

[1] Stockton v. Lederer, 262 Fed. 173, affirmed 266 Fed. 676.
[2] O. 1012, Treasury Bulletin 12-20-792.
[3] O. D. 278, Treasury Bulletin 20-19-511.

to them by the will of the testator. In 1918, prior to the termination of the trust, a certain sum was received by the trustee from the sale of subscription rights on stock, which sum was added to the corpus of the estate. Upon the assumption that the subscription rights on stock which were sold were granted directly to the trust company as trustee, it was held that the entire proceeds from their sale, which was added to the corpus of the estate for future distribution, must be reported by the trustee in a return for the estate on Form 1040 (Revised), together with all other income so accumulated during the taxable year.[4]

[4] O. D. 507, Treasury Bulletin 20-20-939.

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CONTRIBUTIONS TO CHARITIES. No deduction may be taken for an amount of income retained or permanently set aside for the benefit of a religious, charitable, scientific or educational corporation where such corporation is not fully in existence at the time the income is so retained or set aside.[1]

[1] A. R. R. 280, Treasury Bulletin 46-20-1305.

[Page 78.]

BUSINESS EXPENSES. Amounts expended by an estate on account of special assessments for the maintenance or repair of streets or for sidewalk improvements levied upon property used in a trade or business, if the same is necessary in the conduct of such trade or business, constitute allowable deductions. In case any of the property of the estate is used for residential purposes by anyone beneficially interested in the estate, the amounts expended in payment of assessments levied upon such property for maintenance and repairs can not be deducted by the estate unless the rental value of the property is included in the gross income of the estate. Amounts paid out for maintenance of streets and sidewalks used in connection with the business of the estate may be claimed as a deduction for the year in which such expenses were paid or accrued in accordance with the method upon which the taxpayer's books of account are kept. Amounts expended for replacements can, under no circumstances, be claimed as a business

expense. Such items are held to be investments of capital.[1] An amount paid by the committee for a taxpayer who has been declared mentally incompetent, in settlement of attorney's fees incurred by the taxpayer in resisting the proceedings looking to declare him incompetent, is not a necessary expense incurred in the management of the affairs of such taxpayer but is a personal expense and therefore not deductible by the committee in computing the net income of the taxpayer.[2] Where trustees under a will hold real estate and are obliged to pay attorney's fees for services in connection with litigation brought by one claiming an interest in the property, it has been held that such fees are not deductible from the income of the trust as an ordinary and necessary expense even though the trustees are not authorized to sell any part of the property out of which to satisfy the attorney's fees or the tax imposed. Such expenses are held to constitute a part of the cost of the property and are chargeable against the corpus of the estate.[3]

[1] O. D. 613, Treasury Bulletin 31-20-1102. If such replacements, however, are used in connection with the business of the estate, a reasonable amount may be claimed for exhaustion, wear and tear of the property, including obsolescence.

[2] O. D. 603, Treasury Bulletin 30-20-1089.

[3] A. R. R. 284, Treasury Bulletin 42-20-1248.

[Page 78.]

Footnote 40.

Add:—O. D. 537, Treasury Bulletin 23-20-988.

[Page 79.]

TAXES. Where property owned by an estate is sold, the amount of the stamp tax upon the deed conveying title to the property constitutes an allowable deduction in the return of the estate.[1] The inheritance tax is entirely separate and distinct from the income tax. In substance, the Government collects a tax on the income accruing up to the moment of death. It then takes out of the estate a certain part as a transfer tax. The remainder passes and becomes the estate, the income of

[1] O. D. 632, Treasury Bulletin 53-20-1135.

which is taxable while it is being administered. When the estate passes into the possession of an executor, he holds in trust for the United States that portion which is required to be deducted as a transfer tax.[2] The remainder is the estate which he holds in trust for creditors and beneficiaries and the income of which is taxable. When he pays to the Government that which he has been holding in trust for it, he pays nothing out of the estate the income of which is subject to tax. The law separates this part of the original estate from that part which is to be treated as the estate for purposes of income taxes. Therefore, the Federal estate tax is not deductible in computing the income of estates of deceased persons or beneficiaries thereof.[3] Similarly, interest upon the unpaid balance of a Federal estate tax is not deductible, such interest being described by the statute as a part of the tax.[4]

[2] Interest on any such sum so held in trust is income to the estate and taxable as other income accruing to the estate. (O. D. 656, Treasury Bulletin 36-20-1183.)

[3] Prentiss v. Eisner, 260 Fed. 589, affirmed by the Circuit Court of Appeals, Second Circuit, June 16, 1920. Op. A. G. 1, Treasury Bulletin 16-20-875. See also O. 812, Treasury Bulletin 13-19-419.

[4] O. D. 594, Treasury Bulletin 29-20-1074. See Revenue Act of 1918, Section 406.

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INTEREST. Where interest has accrued on notes of a decedent and been deducted from the estate in determining the amount of the gross estate for estate tax purposes it has been held that such interest, where paid by the administrator, is deductible from the income of the estate unless the decedent kept his books on some basis other than that of actual receipts and disbursements. Only the accrued interest on outstanding obligations may be deducted, and where interest upon an old note has been capitalized by giving a new note, representing the aggregate of the old note with the interest accrued, only the amount of interest accrued upon the new note can be deducted, the new note representing payment of both principal and interest of the old.[1]

[1] A. R. R. 113. Treasury Bulletin 21-20-953.

[Page 79.]

Footnote 41.

Add:—O. D. 537, Treasury Bulletin 23-20-988.

[Page 80.]

DEPRECIATION. Replacements to streets and sidewalks used in connection with the business of an estate are not deductible as business expense but will constitute the subject of an annual allowance for depreciation.[1]

[1] O. D. 613, Treasury Bulletin 31-20-1102.

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WORTHLESS DEBTS. Where a decedent was coindorser on the note of a corporation in process of liquidation at the time of his death, and his share of the liability was not known at the time of his death but was determined at the end of 1918 and paid by the administrator in the early part of 1919, the payment was held deductible in the administrator's return in the year in which the liability was paid and charged off on the administrator's books, provided all the circumstances indicated the debt to be worthless and uncollectible, and that legal action to enforce payment would in all probability not have resulted in the satisfaction of execution on a judgment. The same decedent was not permitted to deduct the difference between the appraised value of a subrogated claim against a company whose past due note decedent had been obliged to pay as indorser and the amount paid to the bank payee. The theory of this decision was that the transaction was not a closed and completed one. So long as the claim against the company was not disposed of by the administrator, the exact amount of the loss, if any, could not be definitely determined, and, therefore, could not be claimed as a deduction.[1]

[1] O. D. 556, Treasury Bulletin 25-20-1017.

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Footnote 47.

Where the income of an estate is to be distributed periodically and the trustees sell part of the principal or corpus of the estate at a loss, the beneficiaries are not allowed to deduct any part of the loss in their returns. (O. D. 156, Treasury Bulletin 5-19-255.)

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DECEDENT'S ESTATE DURING ADMINISTRATION. During the period of administration it is the duty of the administrator or executor to make return and pay whatever tax may be due on income received by the estate of a deceased person.[1] Income of an estate during the period of administration not paid or credited to the beneficiaries is taxable to the estate, even though the beneficiaries are as a matter of law entitled to be paid or credited with such income during the year.[2] Where the deceased owner of real estate has not in his will directed the sale of real estate or devised the same upon trust to be sold to pay debts, legacies, or for other purposes, or done such other act as to effect equitable conversion of his real estate at his death, and the personal property is sufficient to pay all the debts and legacies, the real property does not form part of the estate and the executor will not be required to make a single return for the income from the real estate and the personal estate of the decedent during the period of administration, even though the real estate was devised to a trustee.[3]

[1] O. D. 598, Treasury Bulletin 29-20-1082.

[2] T. B. R. 47, Treasury Bulletin 16-19-46. The rule in New York that one who receives a bequest of the income of a specified sum, the property of the decedent being income producing at the time of his death, is entitled to such income from the date of death (Re Stanfield's Estate, 135 N. Y. 292, 31 N. E. 1013) has no application to interests arising under a will creating a trust of the residuary estate, and directing the payment of the income of certain portions thereof to specified individuals. The trust being created only at the expiration of administration, the right to the income of the trust fund accrues only at that time; and consequently, under the Revenue Act of 1916, no part of it is taxable to the individual beneficiary during the period of administration, but the whole of it is taxable to the estate as an entity. (Revenue Act of 1916, sec. 2 (b)). The result is the same where the will creates a right in the legatee to income from the date of the death, since such income is not payable until the completion of administration, and until that time the property producing the income is part of the estate in process of adminstration. Under the Revenue Act of 1918, however, the estate is entitled to deduct income properly paid or credited to legatees during the period of administration, and such income is taxable to the beneficiary. (L. O. 1051, Treasury Bulletin 38-20-1206, revoking S. M. 783.)

[3] S. 1229-A, Treasury Bulletin 13-20-811, revoking Solicitor's Memorandum No. 1229. The same ruling applies under Section 2 (b) of the Revenue Act of 1916, as amended.

The demand of the Alien Property Custodian for the interest of a beneficiary, who is an alien enemy, entitles the Alien Property Custodian to receive from the administrator or executor the net amount found to be due by the court administering the estate of the alien enemy. After the distribution and receipt by the Alien Property Custodian of the enemy's share in the estate no further tax can be required to be reported or paid by the Alien Property Custodian. However, up to the date of the distribution of the estate it is incumbent upon the administrator or executor to report and pay the income tax due on the estate, the Alien Property Custodian being concerned only with the net amount found to be due the enemy on distribution.[4]

[4] O. D. 598, Treasury Bulletin 29-20-1082.

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Credits to Trust or Beneficiary. The undistributed net income of a trust estate under the control of a resident fiduciary and subject to the jurisdiction of a State or Territory of the United States, or of the District of Columbia, is taxable in the same manner as income accruing to an unmarried resident individual, irrespective of the fact that the creator of the trust may be a non-resident alien and irrespective of the fact that the ultimate beneficiaries may be non-resident aliens. The exemption to which a single person is entitled may properly be claimed regardless of the citizenship or residence of the creator of the trust or of the beneficiaries for whom the income is retained. The income of an estate in process of administration in the courts of a State or Territory of the United States or of the District of Columbia by resident fiduciaries is taxable as an entity, irrespective of the fact that the decedent may have been a non-resident individual and the beneficiaries or distributees may be non-resident aliens and the income may be, in part or whole, derived from foreign sources. The same specific exemption may properly be claimed as that to which a single person is entitled regardless of the citizenship or residence of the creator of the trust or of the beneficiaries.[1]

[1] A. R. M. 37, Treasury Bulletin 13-20-810.

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Distribution of Income of Trust Estates. A profit from the sale of property during life tenancy which is held for future distribution to remaindermen is "undistributed" income and is taxable as an entity in the hands of the trustee of the estate.[1] When a trust provides for the distribution of income "when received" the beneficiary should account for it personally, whether distributed or not. The creator of the trust is not liable for income tax with respect thereto.[2]

[1] O. D. 560, Treasury Bulletin 26-20-1029.
[2] S. 961, Treasury Bulletin 1-19-69.

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INCOME NOT ACTUALLY PAID TO BENEFICIARIES IN YEAR. Under a will a trust fund was established, the income to be distributed to the beneficiary periodically during her natural life. The trust fund was invested in two mortgages on property owned by the beneficiary and by verbal agreement it was provided that the beneficiary should pay no interest upon the mortgages and that the trustees should pay her no income from the trust. It was ruled that the fact that the trust fund was invested in a mortgage belonging to the beneficiary and that the contract was entered into by which the trustees agreed not to collect the interest due them, the beneficiary agreeing to receive no income from the trust estate, did not alter the fact that income had accrued to the credit of the estate and that the beneficiary was in constructive receipt of income from the trust. If for any taxable period the net income of the estate should be $1000 or more, including the entire amount of interest receivable upon the mortgage, the trustees would be required to render a return on Form 1041 and the beneficiary would be required to make a return of her distributable share of the income of the trust fund. She would, of course, be entitled to deduct the amount of interest payable within the year upon the mortgages on her property.[1]

[1] O. D. 606, Treasury Bulletin 30-20-1093.

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Estates and Trusts Which Cannot Be Treated as a Unit. In the case of certain estates and trusts it is recognized that the

estate or trust can not be treated as a unit for income tax purposes and may represent an aggregate of distinct interests to all of which the fiduciaries are responsible; in such cases the procedure stated in this paragraph should govern. The following are recognized as cases which can not be treated as a unit: (a) When there is income distributable periodically and also income which is to be accumulated in trust, held for future distribution, or added to the corpus; (b) when there is income distributable periodically and also income (according to the Federal income tax statutes and regulations) which is not distributable periodically under State law, e. g., gains from sale of capital assets, stock dividends; (c) when there is income distributable periodically and deductions (according to Federal income tax statutes and regulations) which are not deductible under State law from the distributable income, e. g., losses from the sale of capital assets, depletion, depreciation. In ascertaining whether an estate or trust comes within any one of the cases just enumerated, the provisions of the Federal statutes and regulations—rather than the provisions of the will or trust and the provisions of State laws—will determine what items constitute taxable gross income or allowable deductions; the provisions of the will or trust and of State laws will determine the allocation of items of gross income or deductions; that is, to which of the different interests making up the whole such items shall be charged or allowed. In cases in which an estate or trust cannot be treated as a unit the items of gross income and deductions, as determined by the Federal income tax statutes and regulations, must be scrutinized and classified in accordance with the provisions of the will or trust, or rules of local law, into two classes. The first class will include the items of gross income and deductions so determined which relate to "undistributed" income, with respect to which the estate or trust is treated as a taxable entity and upon which income the tax is paid by the fiduciary. The second class will include the items of gross income and deductions so determined which relate to the "distributable" income, the tax upon which is not paid by the fiduciary but by the beneficiary. The result will be that the beneficiary to whom income is to be distributed periodically must include in com-

puting his net income the amount actually distributable to him (except exempt income) even though the aggregate of the distributive shares should be larger than the net income of the estate or trust computed as a unit. Any gain, profit, or income which is not periodically distributable must be included in computing the net income of the estate or trust so that the fiduciary will pay the tax upon any excess of the net income of the estate or trust computed as a unit over the aggregate distributive shares.[1]

[1] T. D. 2987, Treasury Bulletin 10-20-781, revoking all previous rulings inconsistent therewith and retroactive to January 1, 1918; O. 1013, Treasury Bulletin 12-20-795-6. For example, a trust is created the income of which is distributable periodically for the life of the beneficiary, the remainder over to others. The trust has the following items of income: Rent, $3,000; interest, $2,000; gain on sale of capital assets, $1,500; cash dividend, $1,000; and deductions, general expenses (all deductible from distributable income), $700; depreciation, $300; loss on sale of capital assets, $3,000. Under the terms of the trust $5,300 will be distributed to the beneficiary, viz, rent, $3,000; plus interest, $2,000; plus dividend, $1,000; less general expenses $700. The gain and loss on the sale of capital assets will be considered capital items affecting the corpus only, and the items of depreciation will not affect the amount to be distributed, there being no rule of State law or provision of the trust requiring this deduction from distributable income. In such a case the fiduciary must report on Form 1041, showing a net income for the trust of $3,500, and must show as the distributive share of the beneficiary the $5,300 to which he is entitled. The beneficiary must account for the amount actually distributable to him as income, viz, $5,300, as provided in section 219 (d) and will be entitled to a credit of $1,000 on account of the dividends in computing the normal tax, but not to any deduction on account of depreciation or capital losses. If there had been no loss on the sale of capital assets so that the net income of the estate or trust was $6,500, Form 1041 should show the distributive share of the beneficiary as $5,300, and the distributive share of the fiduciary as $1,200; and the fiduciary should file a separate return on Form 1040A, reporting $1,200 for taxation.

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Footnote 62.

Add:—It has been held under the 1913 Law that the income of a trust estate which is accumulated and added to the corpus, the beneficiary of which is unascertained, is taxable as income of the trust. (O. 1001, Treasury Bulletin 9-20-774.)

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Footnote 63.

Article 342 of Regulations 45 is applicable only under the Revenue Act of 1918. Where the income of a trust fund is payable only in the discretion of the trustees, such income as the trustees distributed to the beneficiaries during the years 1916 or 1917 was taxable to the recipient personally. (Revenue Act of 1916, Sec. 2-B; S. 1088, Treasury Bulletin 11-19-382.)

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BY WHOM FILED. In case no necessity exists for the appointment of an administrator, the beneficiaries may act jointly, or may duly appoint one of their number as the agent of the estate for the purpose of filing the income tax return of the decedent. In doing so, however, the agent assumes the responsibility for making the return and incurs the liability to the specific penalties provided for in the case of the filing of erroneous, false, and fraudulent returns.[1]

[1] O. D. 702, Treasury Bulletin 43-20-1264.

[Page 86.]

REVOCABLE TRUSTS. The trustee under a revocable trust is required to file a return on Form 1041, revised, showing the grantor as the beneficiary under the trust. The trustee must also file a return of information upon which should be entered the name and address of the grantor in whose return the income should be included.[1]

[1] O. D. 621, Treasury Bulletin 32-20-1116.

[Page 88.]

FOR NON-RESIDENT ALIEN BENEFICIARIES. A fiduciary should file Form 1040 for a non-resident alien beneficiary, even though the individual's distributive share of income is derived from dividends and is less than $5,000.[1] Where two separate trusts are created for the same non-resident alien beneficiary, each trustee is required to render a personal return on Form 1040 or 1040-A on behalf of the non-resident alien, and pay any and all normal tax found by such return to be due and any and all surtax, provided the income is not returned for the pur-

[1] O. D. 58, Treasury Bulletin 1-19-79.

pose of the tax by the beneficiary. If one of the trustees is the representative or authorized agent of the non-resident alien, he may render a complete return on Form 1040 or 1040-A, combining the entire net income from both trusts and take credit on the return for any tax paid by the other fiduciary in behalf of the non-resident alien. If the non-resident alien beneficiary of the two trusts should appoint a resident agent for the purpose of filing his return and paying the tax in his behalf, it would not be necessary for the two trustees to file returns on Form 1040 or 1040-A, provided they have received notice of such appointment. The fiduciaries, however, would not be relieved from liability for rendering returns as such on Form 1041.[2]

[2] O. D. 572, Treasury Bulletin 27-20-1042.

[Page 88.]

FIDUCIARY WHO IS ALSO BENEFICIARY. A fiduciary who is also the beneficiary of the trust should file a return for the estate or trust, and should also file an individual return showing his entire income derived from the estate and from all other sources.[1]

[1] O. D. 208, Treasury Bulletin 10-19-360.

[Page 88.]

Footnote 79.

See Reg. 33 Revised, Art. 29, as amended by T. D. 2988, Treasury Bulletin 11-20-785.

[Page 90.]

TIME FOR FILING RETURN UPON DEATH OR TERMINATION OF TRUST. Where a taxpayer who was granted an extension of time in which to file his 1919 return, died before the expiration of such extension without rendering a return, the return must be filed by the executor or administrator as soon as possible after appointment or qualification and be accompanied by the amount of any tax due, together with interest at the rate of one-half of one per cent per month on the amount of any deferred installments from their respective original due dates until paid.[1]

[1] O. D. 681, Treasury Bulletin 41-20-1234.

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Returns by Ancillary Executors. The ancillary executor of the estate of a non-resident alien should make returns for the estate and pay the taxes due, as agent of the foreign executor, and file personal returns for each non-resident alien beneficiary.[1]

[1] O. D. 292, Treasury Bulletin 23-19-547. The personal returns are filed on Forms 1040 (revised) or 1040 (a) (revised). The ancillary executor should also file a withholding return on Form 1042 (revised) accompanied by certificate 1098 (revised).

[Page 90.]

WHERE FILED. In a case where a decedent, a resident of New York, but at the time of her decease living in California, left property in both States, an executor being appointed in each State, it has been held that since the entire will was probated in New York and only that part pertaining to property located in California was probated in that State in conformity with its laws, the executor in California is in fact an ancillary executor and is not required to file a return for the estate, if the domiciliary executor includes in his return the entire income of the estate.[1]

[1] O. D. 584, Treasury Bulletin 28-20-1060.

[Page 90.]

COLLECTION OF THE TAX FROM DISTRIBUTEES. In a case in which a taxpayer in October, 1919, converted all of his property into cash and distributed it to his wife and sister, so that at the time of his death in January, 1920, nothing remained to be administered or to satisfy his income tax liability, it has been held that the gift tended to defeat the intent and purpose of the income tax law, and that liability for income tax attaches to and follows the property distributed into the hands of the recipients; also that a return for 1919 should be filed on behalf of the decedent and payment of the tax assessed against the estate of the decedent should be demanded of the recipients of the gift.[1] Inasmuch as a residuary estate is the gross estate of the decedent less proper expenses and bequests

[1] O. D. 582, Treasury Bulletin 28-20-1058.

of specific amounts or specific property, and the specific bequests must be paid in full after all debts and expenses are paid, even though nothing remains to constitute a residue, it follows that if an estate is distributed and no provision made for any part of such expenses or specific bequests, a proper residue is not obtained and the residuary legatee has received an amount in excess of that to which he is entitled. Therefore, where the estate of a deceased person has been settled, no provision being made for the payment of income tax, the tax assessable is properly collectible from the residuary legatee.[2]

[2] O. D. 722, Treasury Bulletin 45-20-1295.

[Page 91.]

Information at the Source. A fiduciary is required to file with his return on Form 1041, an information return on Form 1099, covering the distributable share of each beneficiary, regardless of the amount or character of the income comprising such distributable share. This is true even though the entire income of the estate consists of dividends on the stock of domestic corporations.[1]

[1] O. D. 575, Treasury Bulletin 27-20-1045.

[Page 92.]

TRUST ESTATES. Nonresident alien fiduciaries of trusts subject to the jurisdiction of a foreign country are taxable on undistributed net income from sources within the United States, irrespective of the fact that the creator of the trust or estate may be either a citizen or resident of the United States or a non-resident alien and the beneficiaries may be either citizens or residents of the United States or non-resident aliens. An exemption allowed a single person may properly be claimed, provided the fiduciary is a citizen or subject of a country which imposes an income tax and allows a similar credit to citizens of the United States not residing in such country. The income of estates in process of administration in the courts of a foreign country by nonresident alien fiduciaries is taxable as an entity in so far as the income received is from sources within the United States, irrespective of the fact that the de-

cedent may have been either a non-resident alien or citizen of the United States and the beneficiaries in the distribution may be either nonresident aliens or citizens or residents of the United States. The same specific exemption as provided for above may be claimed under the same conditions and limitations.[1]

[1] A. R. M. 37, Treasury Bulletin 13-20-810.

CHAPTER 7.

FARMERS

[Page 95.]
Footnote 3.
See A. R. R. 249, Treasury Bulletin 35-20-1168.

[Page 96.]
Inventories. Because of the impracticability of identifying live stock purchased and live stock raised, and the difficulty of ascertaining actual cost of live stock and other farm products raised, farmers who render their returns upon an accrual basis may at their option value their inventories for the taxable year according to the farm price method, which contemplates a valuation of inventories at market price less cost of marketing. If the use of the farm price method of valuing inventories for any taxable year represents a change in method of taking inventories from that employed in prior years, the opening inventory for the taxable year in which the change is made should be brought in at the same value as the closing inventory for the preceding taxable year (this being the same in effect as valuing the opening inventory on the new basis and crediting income with the excess valuation brought in). However, if such treatment of the opening inventory for the taxable year in which the change is made results in abnormally large income for that year, by reason of the fact that certain live stock or other farms products which were on hand at the beginning are still on hand at the end of the year, then adjustments in the form of an adjustment sheet attached to the return for such taxable year may be made of the taxes for 1915 and each succeeding year to the year in which the change is made. In making such adjustments the farm price method of valuing inventories should be used for each of the preceding taxable years.[1] Where the return of a farmer ren-

[1] T. D. 3011, Treasury Bulletin 18-20-907; A. R. R. 14, Treasury Bulletin 2-20-668.

dered upon an accrual basis represents a change from that of cash receipts and disbursements, the gross profits for the current taxable year must be computed without deducting from the sum of the closing inventory and the sales and other receipts, the inventory at the beginning of the year except—

(a) If any live stock, grain, or other property on hand at the beginning of the taxable year had been purchased and the cost thereof not charged to expense, only the difference between the cost and the selling price should be reported as income for the year in which sold.

(b) But if the cost of such property has been charged to expense for a previous year, the entire amount received must be reported as income for the year in which sold.

This procedure is to be followed in such cases instead of attempting to make an adjustment by recomputing the net income for prior years upon the accrual basis with inventories, except in cases where for the prior year inventories have actually been taken and recorded and records kept of accrued items of expenses, although the returns for those years were made upon the cash receipts and disbursements basis. Where such actual records are available for the prior years, adjustments in the form of an adjustment sheet attached to the return for the current taxable year may be made of the taxes for 1915 and each succeeding year to the year in which the change is made. In making such adjustments the same method of valuing inventories should be used for the current taxable year and for each of the preceding taxable years.[2]

[2] O. D. 636, Treasury Bulletin 34-20-1144. (See the instructions on Form 1040-F under the heading of "Inventories," and Treasury Decision 3011.) O. D. 481, Treasury Bulletin 22-19-537. Where a farmer keeping his accounts on the cash receipts and disbursements basis desires to change to the accrual basis, and actual records or definite proofs are submitted which establish to the satisfaction of the Commissioner the existence of an animal or other production asset on a date previous to any date on which the farmer has paid income tax, inventory adjustments may be made in accordance with the instructions contained on page 4 of Form 1040-F. (O. D. 685, Treasury Bulletin 42-20-1241.)

[Page 98.]

INCOME FROM SALE OR EXCHANGE OF ANNUAL PRODUCE. Where a farmer purchases for a certain price land together with crops growing thereon, the basis for determining gain or loss upon a subsequent sale of the crops is the difference between the cost, or if no part of the purchase price was assigned to the crops, the fair market value thereof at the time of purchase, and the selling price less cost of harvesting and marketing.[1]

[1] O. D. 714. Treasury Bulletin 45-20-1285.

[Page 100.]

EXCHANGE OF FARM PROPERTY. The exchange of farm lands in all cases in which the farm land exchanged has a market value constitutes a completed or closed transaction from which a gain or loss is realized, even though the land received in exchange may be of a similar kind and of similar value.[1]

[1] O. D. 429, Treasury Bulletin 14-20-821.

[Page 101.]

EXPENSE. An individual bequeathed to his widow, for the term of her natural life, various orange groves in Florida, a great many of the trees of which, during a severe frost, were so seriously injured that grafting, special fertilizing, etc., had to be resorted to, to restore them, in spite of which some of the trees died. The widow expended a sum of money from her personal income for the grafting and fertilizing. It has been held that the amounts expended are properly allowable as a deduction for the ordinary and necessary expense of business but the widow may not deduct any amount on account of loss of trees totally destroyed since while the loss tends to reduce the income of the estate, it is not a loss to the life tenant but is a decrease in the corpus of the estate.[1]

[1] O. D. 554, Treasury Bulletin 25-20-1014.

[Page 103.]

LOSSES. In the case of orchards and vineyards acquired subsequent to March 1, 1913, and later destroyed, any deduction for loss should be confined to the amounts of capital orig-

inally invested in the growing trees and in the new nursery stock which was totally destroyed and the amount expended from date of acquirement to date of destruction in an endeavor to bring such trees and stock to an income-producing stage, if not previously deducted as expenses, eliminating all expenditures on account of permanent improvements or on account of trees and vines the growth of which was merely retarded and not entirely destroyed.[1]

[1] O. D. 374, Treasury Bulletin 3-20-690.

[Page 104.]

NET LOSSES. A farmer who in 1919 suffered a net loss may adjust his 1918 tax in accordance with the net loss provision of the Revenue Act of 1918.[1]

[1] O. D. 558, Treasury Bulletin 26-20-1025. For a definition of the term "net loss" and the procedure under Section 204, see page 388 of the 1920 Edition.

[Page 104.]

DEPRECIATION. An owner of an orchard which has reached an income-producing stage is entitled to deduct from gross income an annual allowance for depreciation, based upon the capital invested, which comprises the original purchase price of the trees together with the necessary expenditures incurred in bringing them to the producing age, the rate of depreciation to be determined by the average life of the trees under normal conditions.[1]

[1] O. 797, Treasury Bulletin 1-19-52.

[Page 105.]

Returns of Farmers. The use of Form 1040-F is optional, since it is designed merely to assist farmers in computing their net income. Therefore, it is unnecessary to file same where the taxpayer has made return and paid the taxes due.[1]

[1] O. D. 266, Treasury Bulletin 18-19-476.

CHAPTER 8.

PARTNERSHIPS

[Page 107.]

Limited Partnerships. The following types of limited partnership are held not to be taxable as corporations or associations:

1. A limited partnership organized under the laws of Mississippi.[1]

2. A partnership organized under the laws of Pennsylvania which does not use the word "limited" in the firm name, has no provision for a common seal or for limiting the liability of the members, or for annual meetings of the partners, but which is not dissolved by the death of one or more partners.[2]

The following types of limited partnership are held to be taxable as corporations or associations:

1. A partnership association or limited partnership organized under the Ohio code.[3]

2. A partnership association or limited partnership organized under the Virginia code of 1904.[4]

[1] Hemingway's Ann. Miss. Code. (1917), Secs. 5467-5484. See S. 1160, Treasury Bulletin 20-19-501. The above sections of the Mississippi Code show that limited partnerships formed thereunder are similar to those formed under the New York laws, in that general partners are not afforded limited liability although special partners do enjoy limited liability under certain conditions, and further, in that Mississippi limited partnerships do not sue in the partnership name and are in general so like common law partnerships that they should be treated as such..

[2] O. D. 599, Treasury Bulletin 30-20-1084. The partnership involved in this case had no provision for the free transferability of the interest of a member. It is to be noted that as a general rule limited partnerships of the Pennsylvania type are treated for income tax purposes as corporations. See page 108 of the 1920 edition.

[3] Secs. 8059-8078; see O. D. 444, Treasury Bulletin 15-20-840.

[4] Secs. 2878-2886. The status of Virginia limited partnerships formed under the Act of March 14, 1918, must be determined in each case by a consideration of the certificate of partnership and other pertinent facts. (O. D. 334, Treasury Bulletin 29-19-671.)

[Page 110.]

JOINT OWNERSHIP AND JOINT ADVENTURE. In case two partnerships enter into a single adventure under an agreement to terminate in two years, no part of the profit to be distributable and no drawings to be allowed during such period, the amount of profit realized and determinable each taxable year should be reported proportionately in the respective returns of the partnerships regardless of the agreement. The individual members of each partnership are likewise subject to tax each year on their distributive shares of the profit allocable to each partnership.[1] A partnership may exist in a single transaction as well as in a series of ventures, or an established business.[2] Two parties on several occasions had engaged in the enterprise of buying cattle in the fall, feeding them and selling them in the spring, the profits being equally divided between them. The two parties paid for the cattle by giving the commission merchants their joint note, secured by a chattel mortgage on the cattle. Feed was purchased through the proceeds of another joint note which was discounted at a bank. After they were sold, the notes were taken up and the profits divided equally. The same procedure had been followed in previous years and it was also followed in subsequent years. In one of the later years a resulting loss was borne equally by the two parties. There were no written articles of partnership although it was admitted that the commission merchants with whom they dealt probably considered them to be partners, and a joint bank account was maintained in the names of both parties. The Treasury Department held that the enterprise was taxable as a partnership.[3]

As a general rule, a corporation cannot enter into a partnership for the reason that to allow a corporation to do so would be to place the power of binding the corporation in hands other than the duly elected directors and to place upon the stock-

[1] O. D. 187. Treasury Bulletin 8-19-325.

[2] 18 L. R. A. (N. S.) p. 976, citing Flower v. Barnekoff, 20 Ore. 132, 25 Pac. 370, and other cases. See also Spencer v. Jones, 92 Tex. 516, 50 S. W. 118.

[3] A. R. R. 257, Treasury Bulletin 35-20-1160.

holders burdens other than those to which they consent.[4] A corporation will not be held as a mining partner against its express refusal to be liable for any portion of the expense of operation, or to be responsible for the operation of mining property in which it has a one-eighth interest, merely because it receives a proportion of the profits realized from such operation equal to its interest in such property.[5]

[4] Pierce v. Madison, etc., R. Co., 62 U. S. 441; Thomas v. Railroad, 101 U. S. 71; Pittsburg, etc., R. Co. v. Keokuk, etc., Co., 131 U. S. 441; Whittenton Mills v. Upton, 10 Gray 582; Aurora State Bank v. Oliver, 62 Mo. App. 390; Mallory v. Hananer Oil Works, 86 Tenn. 598, 8 S. W. 396.

[5] Sol. Op. 36, Treasury Bulletin 36-20-1179. See the paragraph General Partnerships, page 110 of 1920 Edition.

[Page 110.]

Footnote 10.

Article 150 of Regulations 45, Revised, applies to situations arising under the Revenue Act of 1917 and 1918 (O. D. 411, Treasury Bulletin 12-27-90).

[Page 110.]

Footnote 11.

Add:—One of the chief elements of a partnership is the liability of a partner for its debts. Sharing of profits is but evidence of a partnership which may be rebutted by other evidence to the contrary. (Cox v. Hickman, 8 H. L. C. 268; Sol. Op. 36, Treasury Bulletin 36-20-1179.)

[Page 110.]

General Partnerships. An agreement, referred to as "Articles of Partnership," by the terms of which two individuals associate themselves as copartners in business under the name of A (one of the individuals) & Company for the period of five years, and under which one of the so-called partners is paid the same salary which he had theretofore received as an employee from the other individual, one-fourth of said salary being deductible from said individual's share of the profits, and which provides also that all capital is to be contributed by the individual whose name is used in the firm title, three-fourths of the profits going to said individual and one-fourth (less one-fourth of his salary) going to the other individual,

losses to be borne by the partners in the same ratio as profits except that the excess of losses over gains, if any, are payable by the individual receiving three-fourths of the profits, the business to be carried on for the benefit of the firm by the survivor of either of the partners until the close of the current fiscal year in which the other partner may die, and upon final settlement the entire capital of the partnership and any increase thereof to go to the individual receiving three-fourths of the profits, or his estate, is held to be a partnership under the laws of Pennsylvania.[1]

[1] S. 1361, Treasury Bulletin 14-20-820.

[Page 113.]

Deductions. An individual may deduct from his gross income the ordinary and necessary expenses of his business, but this does not permit an individual who is a member of a partnership to deduct from his personal income any amounts expended therefrom for and on account of the partnership. The individual members of a partnership and the partnership itself are treated separately for income tax purposes, and the individuals comprising the partnership are not considered to be engaged in the business conducted by the partnership merely because they are members of the firm.[1]

[1] O. D. 593, Treasury Bulletin 29-20-1073.

[Page 113.]

BUSINESS EXPENSE. Under the rules of various exchanges, seats must be issued in the names of individuals and may not be issued in the name of a partnership. In the case of a partnership which purchased seats on various exchanges from partnership funds, the seats being issued in the names of the individual members of the partnership, who might buy and sell for themselves as well as for the account of other persons, the amount expended being charged to "membership account" and carried as a capital expenditure on the partnership books, it has been held that the amounts so expended are investments of capital and not deductible as business expenses.[1]

[1] O. D. 473, Treasury Bulletin 17-20-885. In this case the partnership agreement contained no provision as to the disposition of the seats upon the termination of the partnership.

[Page 114.]

INSURANCE PREMIUMS. Premiums paid by a partnership for accident and health insurance policies covering the lives of the individual partners are not deductible from gross income of the partnership.[1]

[1] O. D. 243, Treasury Bulletin 13-19-422.

[Page 114.]

Profits to Be Reported by Partners. Where a distribution of partnership profits is made in securities the partners will nevertheless be taxable with respect to their distributive shares of the net income of the partnership for the taxable year. No gain need be reported nor can any loss be claimed on account of any difference between the book value of the securities distributed and their market value at the date of distribution. In other words, the distribution of partnership profits in the form of securities, like a distribution of partnership assets upon dissolution, does not constitute a closed and completed transaction. To hold otherwise would be to hold that a person might sell at a profit or a loss to himself. The realization of any gain or loss with respect to such securities depends upon their subsequent sale after distribution.[1] Income from a particular source can not be allocated to one partner, but must be divided *pro rata* among the several partners.[2] Where a member of a partnership died owning certain shares of the common stock of a company subsequently becoming insolvent and under the plan of reorganization of such company holders of the common stock were required to pay a certain assessment per share, which assessment the decedent's estate was unable to meet, and where the partnership advanced the sum called for and underwrote the reorganization receiving for its services certain shares of stock of the reorganized company, as well as an amount of money, all of which was turned over to the decedent's estate and never entered upon the partnership's books, it has been held that since the stock and cash received by the partnership were for serv-

[1] T. B. R. 34, Treasury Bulletin 10-19-354.
[2] O. D. 140, Treasury Bulletin 4-19-221.

ices performed by it as underwriter, such compensation represented taxable income to the members of the partnership regardless of the fact that no distribution of such funds was made to them and irrespective of the reason for which the partnership entered into the transaction.[3] Where an individual member of a partnership received a salary for services performed as an employee of a city and, in accordance with his contract with the firm, turned over to it as the value of his time the entire amount so received, it has been ruled that the individual partner might deduct the amount of the salary in his personal return as a business expense, but that no exemption could be claimed by the partnership, since to allow the amount received by it to be treated as exempt income would in effect be to regard it as an employee of the city, which was not the fact.[4] The same rule applies where a partner turns over to the partnership the fees received by him as notary public under commission from a state.[5]

[3] O. D. 542, Treasury Bulletin 24-20-998.
[4] A. R. M. 25, Treasury Bulletin 4-20-702.
[5] O. D. 648, Treasury Bulletin 35-20-1167.

[Page 115.]

DIVIDENDS. In the case of a partnership sustaining an operating loss and receiving dividends liable to surtax in the hands of the individual partners, such operating loss is to be applied to the reduction of such dividends so that only the *net* distributive shares of the partnership income will be included for purposes of the surtax.[1]

[1] A. R. M. 13, Treasury Bulletin 1-20-659.

[Page 115.]

INTEREST ON NATIONAL BONDS. Where Liberty bonds are subscribed for and continuously held by a partnership and one of the partners purchases the bonds directly from the partnership, the purchaser is entitled to the exemption which is conditioned upon original subscription to and continuous holding of the bonds. The basis of the exemption will be an amount of the bonds not in excess of (1) his original share of the bonds held by the partnership, or (2) his share of such

bonds not sold by the partnership plus the amount bought by him from the partnership; whichever amount is smaller. However, if the bonds are purchased from another partner or they are sold by the partnership and repurchased by him in the open market, he can not claim such exemption in respect to any amount of the bonds so acquired.[1]

Where partnership was an original subscriber to Liberty bonds of the Fourth Liberty Loan and was reorganized as a corporation, an individual member of the partnership purchasing from the corporation certain of such bonds taken over will not be considered the "original subscriber" thereof.[2]

[1] O. D. 362, Treasury Bulletin 2-20-672.

[2] O. D. 502, Treasury Bulletin 20-20-932.

[Page 115.]

Footnote 33.

Add:—T. D 2858.

[Page 117.]

CREDIT FOR TAXES. The manner in which credit is taken by a partnership and the individual members thereof for taxes paid to and withheld at the source by a foreign government on royalties payable to such partnership is described in another chapter.[1] There is no provision in the law whereby any tax paid by a partnership or any excess tax paid by the partners thereof may be credited against any tax liability of a successor corporation incorporated prior to July 1, 1919. The only remedy in such case is the filing of claims for refund.[2]

[1] See page 485 of 1920 edition and supplement.

[2] O. D. 457, Treasury Bulletin 15-20-854. See Revenue Act of 1918, Sec. 330, paragraph 3; Reg. 45, Art. 933.

[Page 117.]

INCOME EXEMPT TO PARTNERS. A member of a partnership who has performed services in the military forces of the United States during the present war, and according to agreement has turned over to the partnership the compensation received for such services, may in reporting his distributive share of the partnership's income exclude from his return an

amount equal to the sum received for military services and turned over to the partnership, but not in excess of $3,500. The other partner must report his entire distributive share of the income regardless of the fact that a portion of it was derived from his partner's compensation for military service.[1] An individual member of a partnership receiving a salary for services performed as an employee of a city, who turns over the entire amount so received to his firm as the value of his time, may deduct the amount of the salary in his personal return as a business expense, but the partnership may claim no deduction with respect thereto.[2]

[1] O. D. 121, Treasury Bulletin 3-19-182.
[2] A. R. M. 25, Treasury Bulletin 4-20-702.

[Page 117.]

CONTRIBUTIONS TO CHARITIES. The proportionate share of contributions to charities made by a partnership may be claimed by the individual members of the partnership to an amount not in excess of 15% of the net income of the individual partners as computed without such deduction.[1]

[1] O. D. 185, Treasury Bulletin 8-19-322.

[Page 118.]

READJUSTMENT OF PARTNERSHIP INTERESTS. The effect of the admission to a partnership of a new partner will depend upon the terms of his admission. If, under the terms of the partnership agreement he contributes property or cash to the capital of the partnership he acquires a right, upon dissolution, to a return of his contribution together with his proportionate share of the net profits of the partnership business, and in the meantime to a corresponding share in the net earnings of the partnership. There is no realization on the part of any partner. If, on the other hand, he purchases, for cash, an interest in the existing partnership, it is clear that what he has acquired is simply a right to share in the profits of the partnership during its continuance and in any sum remaining, upon the dissolution of the partnership, after the satisfaction of creditors and of the equities as between the contributing partners. Since this would represent a purchase, by the incoming

partner, there could be no realization as to him, and, as to the members of the former partnership, the amount paid by him will clearly be income to them in direct proportion to their respective interests in the former partnership and should be returned by them as such.[1]

[1] Sol. Op. 42, Treasury Bulletin 36-20-1182; O. 816, Treasury Bulletin 3-19-197.

[Page 119.]

Footnote 45.

Add:—T. B. R. 64, Treasury Bulletin 22-19-536.

[Page 120.]

Footnote 47.

Add:—For the ruling in the case of partnerships with a fiscal year ending in 1916, and the application of the different tax rates in such cases, see O. 1016, Treasury Bulletin 14-20-833.

[Page 121.]

Returns By Partnerships. As the death or withdrawal of a partner ordinarily dissolves the partnership, a return would be required covering the period from the beginning of the partnership's taxable year to the date of its dissolution. If the business of the partnership is continued as such, a new accounting period would be established upon the necessary reorganization of the partnership, and its next return should cover the period from the date of reorganization until the end of the taxable year.[1]

[1] O. D. 228, Treasury Bulletin 12-19-403.

[Page 124.]

EXTENT TO WHICH TAXABLE. In a recent case it appeared that two members of a British partnership, engaged in the cotton business, resided in England, and the third resided temporarily in the United States. The partnership maintained an office in this country for the purpose of *purchasing* cotton to be shipped abroad. The purchase price was paid by draft drawn on England. None of the cotton so purchased was sold within the United States, nor were any of the profits of the sale received in this country. The Treasury Department held

that any income derived from the sale of such cotton was not taxable as income from sources within the United States, since the sale was consummated in a foreign country through transactions by the home office. The third member of the partnership who remained within the United States seven or eight months of the year for the purpose of transacting the partnership business, and who returned to Europe when this purpose was accomplished, was held to be a non-resident alien and therefore not taxable with respect to his share of the partnership profits so held to be from sources without the United States.[1]

A foreign partnership is liable for tax under the 1917 act on the entire amount of profit derived from the sale of goods through its branch office or through its agencies in the United States. The basis of computation of profits should be the difference between the cost of the goods sold through its branch office or agent in the United States and the price received therefor and not merely the amount disclosed by the books of the branch office in the United States.[2]

[1] O. D. 593, Treasury Bulletin 29-20-1072.

[2] O. D. 311, Treasury Bulletin 25-19-585.

CHAPTER 9.

PERSONAL SERVICE CORPORATIONS

[Page 128.]

CERTAIN CORPORATIONS EXCLUDED. The fact that a corporation 50% or more of whose gross income consists of gains, profits or income derived from trading as a principal, is not a personal service corporation, does not necessarily imply that a corporation 50% or more of whose gross income was not derived from such sources is to be considered a personal service corporation independently of the other conditions stated in the law and regulations. As stated in the 1920 edition, it is now ruled that a corporation cannot be considered a personal service corporation when another corporation owns or controls substantially all of its stock, or when substantially all of its stock and all the stock of another corporation (not itself a personal service corporation) forming part of the same business enterprise, is owned or controlled by the same interests.[2] In a case in which this ruling was applied, the recommendation has been made that the ruling be modified so as to allow both the parent corporation and its subsidiaries to be classed as personal service corporations, provided they fulfill all other requirements for such qualification.[3]

[1] O. D. 1, Treasury Bulletin 1-19-4.
[2] Reg. 45, Art 1524.
[3] A. R. R. 46, Treasury Bulletin 13-20-802.

[Pages 128 to 132.]

Definition: Personal Service Corporation. The Revenue Act of 1917 contained a provision to the effect that in the case of a trade or business "having no invested capital or not more than a nominal capital," there should be levied, assessed, collected, and paid an excess profits tax of 8% of the net income.[1] The

[1] Revenue Act of 1917, Section 209.

regulations interpreting this provision stated that it applied primarily to occupations, professions, trades and businesses engaged principally in rendering personal service in which the employment of capital is not necessary and the earnings of which are to be ascribed primarily to the activities of the owners. These regulations also provided that no weight would be given to the fact that a business was carried on by means of personal services, unless the principal owners were regularly engaged in the active conduct of the business.[2] It will be noted that this provision of the Revenue Act of 1917, as construed by the Treasury Department, is closely analogous to the personal service corporation provision of the Revenue Act of 1918. Several cases have arisen in which the applicability of the above provision of the Revenue Act of 1917 and the personal service corporation provision of the Revenue Act of 1918, or both, has been discussed at some length with reference to a more or less complicated state of facts.

The question whether a particular business is one having not more than a "nominal capital" or is such as to render a corporation a personal service corporation within the meaning of the Revenue Act of 1918, involves in each case an extensive examination of such business and the manner in which it is conducted. It is beyond the scope of this work to describe at length and in detail the businesses involved in the rulings of the Treasury Department upon this question. There are stated below, however, certain general principles enunciated by such rulings for guidance in connection with the determination of the question in respect of any particular business.

1. In order to be classed as a concern with nominal capital or as a personal service corporation, the income of a corporation must not result in *substantial* degree from the ownership of property, such as patents.[3]

2. In order to be classed as a concern with nominal capital or as a personal service corporation, an agency acting as sell-

[2] Reg. 41, Art. 71.

[3] T. B. M. 9, Treasury Bulletin 1-19-135; O. D. 2, Treasury Bulletin 1-19-5.

ing agent must in no instance acquire title to the products handled.[4]

3. In order to be classed as a concern with nominal capital or as a personal service corporation, a company in the commission business must not be liable to the consignor for the selling price of the product sold.[5]

4. In order to be classed as a concern with nominal capital or as a personal service corporation, a commission house or agency must not extend substantial credit to firms for which it acts as agent.[6]

5. Where the income of a concern is to be ascribed to a *combination* of the activities of the principal owners and stockholders and the activities of the managers and various agencies who are not stockholders, the concern will not be entitled to be classed as one with a nominal capital or as a personal service corporation.[7]

As a result of the application of the above principles and the other applicable tests stated at length in the 1920 edition, the following businesses have been held not to fall within the definition of concerns with a nominal capital or personal service corporations:

1. A freight forwarding business which advances various costs of carriage.[8]

2. A corporation engaged in the business of retailing automobiles, which business is that of the ordinary commercial enterprise in which capital is a material factor in the conduct of the business.[9]

3. A sanitarium owned and operated by doctors which derives income from the buildings and grounds by housing patients.[10]

A corporation conducting a commercial school, having both

[4] A. R. M. 42, Treasury Bulletin 17-20-880; A. R. R. 23, Treasury Bulletin 6-20-724.

[5] A. R. R. 23, Treasury Bulletin 6-20-724.

[6] A. R. R. 50, Treasury Bulletin 20-20-929; A. R. R. 46, Treasury Bulletin 13-20-802.

[7] A. R. M. 59, Treasury Bulletin 26-20-1023.

[8] A. R. R. 7, Treasury Bulletin 29-19-622.

[9] T. B. R. 58, Treasury Bulletin 19-19-492.

[10] O. D. 2, Treasury Bulletin 1-19-5.

home study and resident instruction departments, which does not lodge or board any students, and to which the principal owners give all their time and attention in the preparation of courses, syllabus of work, inspection of higher lessons, and settling points in dispute, has been held to be a concern with nominal capital only and a personal service corporation under the Revenue Act of 1918.[11]

[11] A. R. R. 24, Treasury Bulletin 27-27-36.

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Distributive Shares of Stockholders in Personal Service Corporation. In view of the fact that personal service corporations are not required to file consolidated returns, a profit realized or loss sustained by a personal service corporation, attributable to its ownership of stock in another personal service corporation, should be accounted for in the same manner as in the case of an individual stockholder. Where the business of a personal service corporation results in an operating loss, such loss will be divided among the stockholders at the close of its taxable year in proportion to their respective shares, and will constitute an allowable deduction in their returns of annual net income.[1]

It has been contended that certain expressions of the Supreme Court in the stock dividend case[2] indicate the invalidity of the provision of the Revenue Act of 1918 taxing the stockholders of personal service corporations upon their distributive shares of the net income of the corporation. The Treasury Department, however, disagrees with this view and has ruled that the provisions of the statute respecting personal service corporations remain unaffected.[3]

[1] O. D. 581, Treasury Bulletin 28-20-1057.
[2] Eisner v. Macomber, 252 U. S. 189.
[3] O. D. 679, Treasury Bulletin 41-20-1232.

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Taxation of Stockholders of Personal Service Corporations With Fiscal Year Ending in 1919. The stockholder of a personal service corporation which closed its books on January 31, 1919, and December 31, 1919, having secured permission to

change its accounting period, such stockholder keeping his books on a calendar year basis, must include in his 1919 return his share of the corporate earnings, whether distributed or not, for the fiscal year ending January 31, 1919, and for the eleven month period ending December 31, 1919. That portion of the amount received attributable to 1918 will be subject to tax at the rates in effect for that year.[1]

[1] O. D. 453, Treasury Bulletin 15-20-850. The method of calculating the 1918 tax is set forth in the 1920 edition.

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Procedure in Claiming Personal Service Status. A corporation filing returns on Form 1120 and subsequently desiring to establish its status as a personal service corporation should adopt the following method of procedure:

It should file amended returns on Form 1065 accompanied with claim for refund on Form 46 for the tax or installments thereof paid. The individual members of the corporation should also file amended returns accompanied with claims in abatement, Form 47, covering the additional assessment shown by such returns.

In the event that the corporation is found to be taxable as an ordinary corporation the claim for refund will be disallowed. In case the corporation establishes a personal service status, the claim for refund will be allowed for the tax paid by the corporation, and the claims in abatement will be disallowed and assessment made to the extent of the additional tax shown to be due on the amended individual returns. Where this procedure is adopted, however, the installments of tax which become due prior to determination of the status of the corporation as shown by its return, as originally filed, must be paid on or before the due dates. Such installments are not subject to either abatement or credit, but can only be covered by supplemental claim for refund.[1]

[1] O. D. 614, Treasury Bulletin 31-20-1103.

CHAPTER 10.

CORPORATIONS

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POOLING OF CORPORATE STOCK. Where the holders of the entire common stock of a corporation agree to pool their stock interests and share in a certain portion of the profits accruing to the corporation according to a fixed arbitrary percentage rather than in proportion to their respective stock holdings, the corporation is still taxable as such and is not to be treated as a partnership for purposes of the income tax.[1]

[1] S. 1001, Treasury Bulletin 4-19-227.

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TRUSTS NOT TAXABLE AS ASSOCIATIONS. As stated in the 1920 edition, the Treasury Department, in deciding whether a given organization constitutes a "trust" or an "association," now treats the question whether the *cestui que trust* or beneficiaries have a voice in the conduct of the business as the decisive test.[1] If this control is "substantial," an association is held to exist; otherwise a mere trust. In the former event the so-called trust thus held to be an "association" is treated as a distinct entity equivalent to a corporation. Ordinary distributions of income by the trustees are regarded as dividends and as liable only to the surtaxes, the association itself being liable to the corporate income and excess-profits

[1] Crocker v. Malley, 249 U. S. 223; Reg. 45, Art. 1504; S. 1337, Treasury Bulletin 9-20-762; S. 1068, Treasury Bulletin 10-19-351; S. 1205, Treasury Bulletin 27-19-600; O. D. 598, Treasury Bulletin 30-20-1083; O. D. 407, Treasury Bulletin 9-20-763; O. D. 236, Treasury Bulletin 13-19-414; Sol. Op. 56, Treasury Bulletin 36-20-1177; O. D. 654, Treasury Bulletin 36-20-1178.

taxes.[2] If the organization in question is held to be a "trust" as distinguished from an "association", its income is treated in the manner more fully described in another chapter.[3] The question whether a particular organization is to be classed as a "trust" or "association" involves in each case a minute examination of the terms of the instrument creating the so-called trust and the rights of the parties to such instrument. It is deemed inadvisable to repeat at length and in detail the provisions of the instruments involved in numerous rulings which have been made by the Treasury Department upon this point, but there are stated below general principles enunciated by such rulings for guidance in connection with the determination of the question in respect of any particular instrument:

1. It is the extent of the control *vested* in beneficiaries under a trust agreement rather than the extent to which such control is *exercised* that is determinative of the question whether the trust is, in fact, an "association".[4]

2. If the beneficiaries or shareholders have the right under the trust agreement to elect trustees annually, the trust constitutes an "association"; on the other hand, if the trustees appointed by the instrument are to hold office during the entire period of the trust, the right of the beneficiaries or shareholders being limited to filling vacancies, such beneficiaries or shareholders retaining any substantial control over the affairs of the trust, the trust instrument creates a "trust" and not an association.[5]

3. The reservation to the beneficiaries or shareholders of

[2] As an association the organization would be subject also to the capital stock tax imposed by Title X of the Revenue Act of 1918. This subject is treated more fully in Chapter 44 on the capital stock tax. Dealings in the shares or certificates of a so-called trust are subject to the stamp taxes imposed by Title XI, Schedule A, of the Revenue Act of 1918. This subject is also treated more fully in Chapter 45 on the stamp tax.

[3] See Chapter 6 on Fiduciaries.

[4] O. D. 407, Treasury Bulletin 9-20-763.

[5] S. 1068, Treasury Bulletin 10-19-351; O. D. 620, Treasury Bulletin 32-20-1112; S. 1337, Treasury Bulletin 9-20-762.

the right to direct and approve the terms of sale of the trust property will constitute the trust an "association".[6]

4. A provision authorizing the trustee or trustees to call upon the beneficiaries or shareholders to pay certain items, such as costs, fees and expenses, in the event that the income of the trust is insufficient, will constitute the trust an "association".[7]

5. Where an agreement between a reorganization committee and the bondholders of a company gives power (a) to the bondholders to terminate the trust (this alone is not sufficient); (b) to terminate the authority of the committee to continue business operations, and (c) to fill vacancies in the committee if dissatisfied with the committee's choice, the agreement has been held to create an "association."[8]

6. If the trustee is given absolute control over the affairs of the trust, in other words, if the trustee is given all the rights and powers which would be his if he were conducting a business of which he was the sole owner, the instrument creates a mere "trust" and not an "association."[9]

7. Where a majority in amount of the shares of beneficial interest in the trust are owned by the trustees as beneficiaries so that to the extent of such ownership the trustees and beneficiaries or shareholders are identical, the beneficiaries are held in fact to control the trustees, even though no control is vested in such beneficiaries under the terms of the trust instrument.[10]

[6] O. D. 598, Treasury Bulletin 30-20-1083; Sol. Op. 49, Treasury Bulletin 39-20-1208.

[7] O. D. 598, Treasury Bulletin 30-20-1083; S. 1205, Treasury Bulletin 27-19-600.

[8] Sol. Op. 49, Treasury Bulletin 39-20-1208.

[9] O. D. 620, Treasury Bulletin 32-20-1112.

[10] Sol. Op. 56, Treasury Bulletin 36-20-1177; O. D. 654, Treasury Bulletin 36-20-1178

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DE FACTO CORPORATIONS. Where articles of incorporation are filed under the laws of Kentucky and business is transacted in the corporate name a return of income received from such business should be rendered for the corporation although

its organization as a corporation has not been perfected in the manner required by law.[1]

If the charter board of a State declared the charter of a corporation forfeited but the corporation had no notice of such action and continued to do business for a number of years as a corporation and made returns to the Federal Government accordingly, the corporation can not now set up the action of the charter board to negative its corporate existence. Until the company surrenders its charter to and the same is annulled by the State, or the charter is annulled in some other manner and the company ceases to operate as a corporation, it must be held to be a corporation for income and profits tax purposes.[2]

[1] S. 972, Treasury Bulletin 2-19-168.
[2] O. D. 365, Treasury Bulletin 2-20-677.

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Footnote 25.

A corporation receiving a charter from the United States Court for China and holding itself out to be a corporation under the laws of the United States will, for the purposes of taxation under the Revenue Act of 1918, be considered a domestic corporation. (O. D. 661, Treasury Bulletin 38-20-1199.)

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CORPORATIONS DOING BUSINESS IN THE PHILIPPINES AND PORTO RICO. A foreign corporation transacting business and having an office in both continental United States and Porto Rico is not subject to income tax in continental United States upon income derived from Porto Rico.[1]

[1] O. 976, Treasury Bulletin 1-20-663. This ruling was made under the 1916 Law, and limits the term "United States" as used in Section 10(a) as not including Porto Rico. To tax such foreign corporations with respect to income derived from Porto Rico would constitute a clear case of double taxation.

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CREATION OF SINKING FUND. If a corporation, in order solely to secure the payment of its bonds or other indebtedness, places property in trust, or sets aside certain amounts in a sinking fund under the control of a trustee, who may be

authorized to invest and reinvest such sums from time to time, the property or fund thus set aside by the corporation and held by the trustee is an asset of the corporation, and any gain arising therefrom is income of the corporation and should be included as such in its annual return. The trustee, however, is not taxable as such on account of the property or fund so held.[1]

[1] T. D. 3056, Treasury Bulletin 35-20-1173.

[Page 147.]

INTEREST UPON LIBERTY BONDS. Where a partnership was an original subscriber to liberty bonds of the Fourth Liberty Loan and was reorganized as a corporation prior to July 1, 1919, and elects to be taxed as a corporation from January 1, 1918, the corporation will be considered "the original subscriber" to the bonds.[1] Each of several affiliated corporations included in a consolidated return is entitled to the same full benefits under the exemption provisions of the several Liberty bond acts to which it would be entitled if not affiliated.[2] When two corporations consolidate, forming a new corporation, the former corporations ceasing to exist, the new corporation can not be considered the original subscriber to bonds of the Fourth Liberty Loan originally subscribed for by the two corporations and taken over by it.[3]

[1] O. D. 502, Treasury Bulletin 20-20-932; O. D. 211, Treasury Bulletin 11-19-373.

[2] T. B. R. 7, Treasury Bulletin 2-19-171.

[3] O. D. 577, Treasury Bulletin 28-20-1052.

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PROCEEDS OF INSURANCE. The proceeds of life insurance policies paid upon the death of the insured to a corporation beneficiary, less any premiums paid by the corporation and not deducted from gross income, are to be included in the corporation's gross income.[1] The option exercised by a corporation beneficiary in allowing the proceeds of an insurance policy to be paid in installments represents in fact an investment of

[1] Reg. 45, Art. 541. Premiums paid by a corporation on insurance policies on the lives of officers and employees might be deducted prior to 1917.

such proceeds. Any interest or profits received over and above the face value of each installment represents taxable income to the corporation for the year in which received.[2]

[2] O. D. 66, Treasury Bulletin 1-19-92.

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SALE OF ASSETS IN VIEW OF LIQUIDATION. Gains derived by a corporation from the sale of its assets with a view of liquidation are measured by the difference between the amount received from the sale and the fair market value as of March 1, 1913, where acquired prior thereto, and are taxable income whether or not the corporation is in process of liquidation.[1]

[1] S. 1090, Treasury Bulletin 11-19-386. The distinction between the cases of Lynch v. Turrish, 247 U. S. 221, 38 Sup. Ct. 537, and Lynch v. Hornby, 247 U. S. 339, 38 Sup. Ct. 543, applies only for purposes of the tax liability of the shareholders as distinguished from the corporation.

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ORDINARY AND NECESSARY EXPENSES. Payments to trustees by a cemetery company, during the taxable year, of a percentage of the proceeds of sales of cemetery lots set aside for a "maintenance fund" to be controlled solely by the trustees thereof pursuant to a provision in the charter of the company requiring such payments, are not deductible from the gross income of the corporation as "ordinary and necessary expenses."[1]

[1] S. 1145, Treasury Bulletin 20-19-515.

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HOLDING COMPANY GUARANTEEING BONDS OF SUBSIDIARY. Payments by a holding company under a guaranty of interest on the bonds of an insolvent subsidiary is a legal deduction from the gross income of the corporation making the payment, either as an operating expense or as interest, or as a bad debt, provided it is charged off the books of account of the guarantor.[1]

[1] S. 1298, Treasury Bulletin 8-20-753. It does not seem that the amount of the deduction need be charged off unless deducted as a worthless debt.

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INTEREST. Interest paid by a corporation on so-called debenture stock, a kind of stock common in England but more or less unfamiliar in this country, has been held deductible from gross income in computing net income.[1]

[1] A. R. R. 237, Treasury Bulletin 33-20-1142. The character of the debenture stock involved in this ruling is thoroughly described in the chapter herein on the excess-profits tax under the heading of borrowed capital.

[Page 151.]

TAXES. Additional taxes assessed against a corporation under the Act of August 5, 1909, and paid during subsequent years are allowable deductions from the gross income of the corporation for the year when paid, but income taxes assessed under the Act of October 3, 1913, and the Revenue Act of 1916, are deductible only if paid prior to January 1, 1917.[1]

[1] O. D. 240, Treasury Bulletin 13-19-418.

[Page 152.]

REDEMPTION OF PREFERRED STOCK. A reserve fund created out of the earnings of a corporation for the purpose of redeeming its preferred stock is not an allowable deduction in computing the net income of the corporation for tax purposes.[1]

[1] O. D. 288, Treasury Bulletin 22-19-537.

[Page 152.]

DIVIDENDS ON STOCK OF OTHER CORPORATIONS. An American corporation may deduct all amounts received as dividends from a foreign holding company whose income was derived entirely from dividends on the stock of another American company.[1]

[1] O. D. 130, Treasury Bulletin 3-19-201.

[Page 152.]

CONTRIBUTIONS TO CHARITIES. Corporations which have erroneously deducted contributions to the Red Cross and other war organizations are not required to file amended returns, but should file with the collector a statement showing the amount

of such deductions claimed, the amount of net income as reported and as corrected, and the amount of additional tax due, accompanied by the additional tax and interest.[1]

[1] M. 2207, Treasury Bulletin 14-19-438.

[Page 152.]

LOSSES IN ULTRA VIRES TRANSACTIONS. Where a corporation suffers a loss as the result of an *ultra vires* act it may not deduct such loss in computing its net income. Where a corporation is authorized by its certificate of incorporation to purchase stocks on a margin, and where there are no laws in the State where it trades in stocks making marginal stock transactions by corporations illegal, if it sustains a loss as a result of marginal trading in stocks, such loss may be deducted in computing its net income, if sustained during the taxable year and not compensated for by insurance or otherwise, unless it appears affirmatively that the transaction was merely colorable and no bona fide purchase of stock was made.[1]

[1] O. 968, Treasury Bulletin 1-20-660.

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AMOUNT OF WAR PROFITS AND EXCESS-PROFITS TAX. An addition to excess-profits tax, on a delinquent or false and fraudulent return, is to be considered a penalty and not a tax except for purposes of collection and is not an allowable credit in arriving at net income.[1]

[1] O. 926, Treasury Bulletin 23-19-551.

[Page 154.]

Receivers for Corporations. A receiver should prepare and file a corporate return for the entire taxable year, including therein the gross income received by the corporation prior to the time of his appointment, and also the gross income received under the supervision of the receiver.[1]

The receiver of a corporation whose fiscal year ended on February 28, 1919, and who was discharged on May 17, 1919, a new certificate of incorporation being filed on May 12, 1919,

[1] O. D. 73, Treasury Bulletin 1-19-102.

should file a return for the original corporation not later than May 15, 1920, covering the period from March 1, 1919, to May 17, 1919.[2]

The receiver liquidating the assets of an insolvent bank is required to file a return for the bank, but in view of the fact that the bank is insolvent he will have no tax to pay. The return may contain a statement to that effect in lieu of the data ordinarily required.[3]

[2] O. D 557, Treasury Bulletin 25-20-1018.

[3] O. D. 114, Treasury Bulletin 2-19-170. Such insolvent bank would have no tax to pay because of Section 22 of the Act of March 1, 1879, which provides that no tax shall be assessed or collected or paid into the United States Treasury on account of an insolvent bank which shall diminish the assets thereof necessary for the full payment of all depositors.

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Footnote 72.

Add:—The net income of a corporation in the hands of a receiver, acting solely as an officer of the court which appointed him and subject to its orders, is not taxable under the 1913 law. This ruling does not apply to the net income of a corporation in the hands of trustees or voluntary liquidators not so acting. (O. 1009, Treasury Bulletin 11-20-787.)

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INCOME TAXABLE IN HANDS OF ASSIGNEE. Income received by assignees appointed by a corporation to liquidate its property and business over a period of years, who have full power of control and management thereof, is taxable. This is true although the business conducted by the trustees in the process of liquidation is not the business which the corporation originally started to conduct. This rule applies to all income received by the trustees, including interest on bank deposits, interest upon deferred payments, and gains upon sales of real property.[1]

[1] O. D. 853, Treasury Bulletin 6-19-280.

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CORPORATIONS LIQUIDATING DURING THE YEAR. A corporation entirely out of business, maintaining its corporate existence merely for the purposes of liquidation, and still holding

income-producing investments not yet due, is required to file income and excess-profits tax returns for each year embracing the liquidating period.[1] Where a corporation is completely dissolved before the close of its taxable year, it has the same time in which to file its final return as if it had continued its existence during its entire taxable year, and in case it files its final return before the time provided by law it can not be compelled at the time of filing such return to pay any tax shown to be due thereon. The first installment of tax is due on the date the return would have been due if it had covered the full taxable year.[2] The Treasury Department will waive the filing of evidence of the completion of liquidation required by the Illinois statutes and will accept a final return from a corporation, if accompanied by a certificate of the court showing that all requirements of the law with regard to dissolution of the corporation and distribution of its assets have been satisfied, except as to evidence of payment of Federal income taxes, and that actual winding up of the corporation merely awaits formal court action. Upon payment of all Federal income tax shown to be due from the corporation, the collector will issue the necessary receipt.[3]

[1] O. D. 231, Treasury Bulletin 12-19-406.
[2] O. D. 692, Treasury Bulletin 42-20-1253.
[3] O. D. 672, Treasury Bulletin 39-20-1214.

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CORPORATIONS IN HANDS OF ALIEN PROPERTY CUSTODIAN. The proper officers of a corporation that has been taken over by the Alien Property Custodian should file a return for the corporation up to the time the property was taken over by the Alien Property Custodian. The board of directors appointed by the Alien Property Custodian is not required to render a return for the corporation while in control of the Alien Property Custodian.[1]

[1] O. D. 148, Treasury Bulletin 4-19-231.

[Page 159.]

CHANGE OF NAME. Since in the conversion of a State bank into a national bank there is not a dissolution of the corpora-

tion, but merely a change of title and the extension of Government supervision thereover, a bank so changing during the taxable year must file one return for the entire year.[1]

[1] O. D. 476, Treasury Bulletin 17-20-888; see also A. R. R. 285, Treasury Bulletin 42-20-1252.

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RETURNS FOR FRACTIONAL PART OF YEAR. A corporation, the charter of which was recorded with the Secretary of the Commonwealth on August 1, 1919, so that on that date, under the laws of the Commonwealth, the company legally became a corporation, should make a return covering the period from August 1, 1919, to December 31, 1919, even though its capital was not paid in nor operations begun until October 1, 1919.[1]

[1] O. D. 574, Treasury Bulletin 27-20-1044.

[Page 160.]

AMENDED RETURNS WHERE CAPITAL CHARGES HAVE BEEN MADE TO INCOME. A corporation may submit amended returns for previous years when, through wrong accounting practice, capital charges have been made to income. An affidavit should be attached, explaining the changes made by such amended returns in the amounts shown on the original return, and explaining why the original returns were not properly prepared and the object of the company in preparing amended returns. Such amended returns will be accepted only when the erroneous charge can be specifically pointed out and the facts proven. The Treasury Department reserves the right to penalize for the making of false returns in the past.[1]

[1] O. D. 113, Treasury Bulletin 4-19-231.

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Footnote 93.
Add:—O. D. 692, Treasury Bulletin 42-20-1253.

[Page 160.]

Footnote 96.
Add:—O. D. 352, Treasury Bulletin 31-19-650.

[Page 162.]

Affiliated Corporations. A claim for credit or refund of excess tax paid by one of affiliated corporations can be made only by the corporation entitled to receive such credit or refund. With respect to refunds, credits, and additional assessments each affiliated corporation occupies a status similar to that of an independent and unaffiliated corporation. An additional tax assessed for the year 1918, on the basis of the consolidated return for that year, must be apportioned among affiliated corporations, and to the extent that each debtor corporation is entitled to receive back a part of taxes paid in prior years, a claim for credit may be filed and the amount of additional tax each subsidiary is required to pay may be reduced thereby by the amount it is entitled to receive. In case the amount payable to the subsidiary exceeds its proportionate part of the additional tax assessed under the consolidated return, it may file a claim for refund for the difference.[1]

[1] O. D. 683, Treasury Bulletin 41-20-1237.

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WHEN CORPORATIONS ARE AFFILIATED. It has been held by the Treasury Department that when the stock of two or more corporations is owned by two or more individuals, or by two or more partnerships, the corporations are not affiliated unless the percentage of stock held by each individual or each partnership is *substantially* the same in each of the corporations. On account of the disparity of holdings of the stockholders in the corporations the Treasury Department would be unable in such cases to compel the corporations to pay a tax based upon a consolidated return, provided the corporations failed to pay such tax voluntarily. Corporations will not be permitted to do what they could not be required to do. Thus, an application to make a consolidated return has been denied in the case of two companies when 24.26% of the stock of the first company was owned by individuals who held no stock whatever in the second company, and more than 6% of the stock of the

second company was held by individuals who held no stock whatever in the first company.[1]

In a recent case a corporation, the majority of whose stock was owned by its president and manager, turned over a branch of its business to a new company not incorporated, the president and manager of the corporation retaining control of the new company. There was no transfer of corporate assets. The new company simply used the assets of the corporation without consideration of any kind, but was operated as a separate enterprise. The Treasury Department held the new company to be merely a branch of the corporation and not a separate entity for income tax purposes, with the result that its income was required to be included in the return of the corporation.[2]

[1] T. B. M. 32, Treasury Bulletin 7-19-304; T. B. R. 52, Treasury Bulletin 16-19-465. This ruling in effect reads an additional word into the statute. Section 240 (b) provides as follows: "For the purpose of this section two or more domestic corporations shall be deemed to be affiliated * * * (2) if substantially all the stock of two or more corporations is owned or controlled by the same interests." The effect of the above ruling is to insert the word "substantially" before the word "same" in subdivision (2) quoted above.

[2] O. D. 467, Treasury Bulletin 16-20-866.

[Page 164.]

Footnote 102.

Add:—Under the Act of October 3. 1917, two corporations might be deemed to be affiliated where one such corporation (a) buys from or sells to another products or services at prices above or below the current market, thus effecting an artificial distribution of profits, or (b), in any way arranges its financial relationship with another corporation as to assign to it a disproportionate share of net income or invested capital (T. D. 2662). This ruling is inapplicable under the Revenue Act of 1918, since under that act there must be a common stock ownership or an ownership of stock in one corporation by the other of the character described in the statute (A. R. R. 123, Treasury Bulletin 22-20-976).

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CORPORATION DERIVING CHIEF INCOME FROM GOVERNMENT CONTRACTS. The income of affiliated corporations which is derived from Government contracts is taxable upon the basis

of the total sum received from that source by the group and not upon the basis of the separate amount received by each corporation.[1]

[1] O. D. 415, Treasury Bulletin 12-20-799.

[Page 166.]

DOMESTIC CORPORATION AFFILIATED WITH FOREIGN CORPORATION. Only such taxes as are actually paid within the taxable year of the domestic corporation may be so credited.[1]

[1] T. B. R. 36, Treasury Bulletin 11-19-388.

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COLLECTION OF TAX FROM ASSETS. The corporate duty of paying income taxes cannot be escaped by dissolution. Where a Montana corporation sold all its property and distributed the proceeds to the stockholders and became dissolved, the additional tax imposed by the Revenue Act of 1916 retroactively from January 1, 1916, to the date of dissolution may be collected from the stockholders to whom the corporate assets have been distributed.[1] If certain of the stockholders are without assets and fail to pay their pro rata share, the remaining stockholders are responsible for the payment of the tax to the extent of the value of the assets of the corporation received by them regardless of their pro rata share under the principle known as the "trust fund" doctrine in respect of corporations.[2]

[1] U. S. v. McHatton, 266 Fed. 602; T. D. 3043, Treasury Bulletin 29-20-1078; see also O. D. 597, Treasury Bulletin 29-20-1079; A. R. R. 43, Treasury Bulletin 12-20-794. In the McHatton case the court said: "Although taxes are not debts, and in respect to them the government is not a creditor, both being of higher nature, no reason is perceived why they are not within the principle that those who gratuitously take all a debtor's property, to the extent thereof, may be held to respond for his present debts and obligations, inchoate or vested, or for the damages thereby inflicted—the sometime "trust fund" doctrine, so far as corporations are concerned." See also O. D. 75. Treasury Bulletin 1-19-107.

[2] O. D. 707. Treasury Bulletin 43-20-1269.

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Transportation Systems. In the case of those railroads which have elected to have their claims adjusted by a board

of referees or the court of claims the Government does not deny the right to compensation, but the amount of their compensation is placed in dispute. The rule is that if the question at issue is whether or not there is any liability, no amount can be accrued and no income reported until the proper tribunal has determined that liability exists; but if the question at issue is merely the amount of an existing liability an estimated amount should be accrued subject to correction when the true amount is known. Therefore, in the case of such roads which have so elected, an accrual should be made. The estimated amount that must be accrued in such cases is the so-called standard return. Under the Act the standard return may be considered as the minimum amount which the various roads under Federal control are to receive as just compensation. The Interstate Commerce Commission's rules require the roads, irrespective of whether or not they have entered into agreements with the President for just compensation to keep their accounts on an accrual basis and to accrue income equal to the standard return. The income tax returns of such roads should be filed n the basis on which their accounts are properly kept, and their accounts showing income as having accrued on the basis of the standard return are correct and therefore their income tax returns should be filed on such basis.[1]

[1] O. D. 642, Treasury Bulletin 34-20-1151.

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Telephone Companies. Telephone companies taken over by the Government, and whose compensation has been fixed by the Government, should include such compensation in gross income, in addition to the income, gains, and profits accruing from other sources during the taxable year. Companies whose compensation has not been fixed should include in the gross income, in addition to other income reported, the amount of operating income received, and when, later on, the President fixes the compensation for the use of their properties during the taxable year, they should file amended returns showing the total income received and recompute the tax on that basis.[1]

[1] O. D. 229, Treasury Bulletin 12-19-404.

A telephone company should make a 1918 return for its accounting period, either calendar or fiscal year, and all income applicable to such period should be included in the corporation's return irrespective of the portion of the year during which it may have been operated under Government control.[2]

[2] O. D. 255, Treasury Bulletin 15-19-449.

CHAPTER 11.

SPECIAL PROVISIONS APPLYING TO INSURANCE COMPANIES.

[Page 177.]

Insurance Company. A corporation, organized to insure its members, limited to jewelers and dealers in goods ordinarily carried in the jewelry trade, against loss or damage by fire, theft, barratry, embezzlement, and transportation, which requires each member to deposit in advance a definite sum sufficient to cover estimated losses and expenses for the ensuing year, the balance of such deposits being returned to members, is a mutual fire insurance company and subject to the taxes imposed by the 1909 Law and the 1913 Law.[1]

[1] Jewelers Safety Fund Society v. Lowe; Jewelers Safety Fund Society v. Anderson, U. S. Dist. Ct., So. Dist. N. Y., July, 1920, T. D. 3078, Treasury Bulletin 44-20-1279.

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Gross Income of Insurance Companies. The premium receipts of "every insurance company," by whatever name they are called, are, unless specifically exempted by the terms of the taxing statutes in question, a part of such company's gross income. Moneys received by way of interest upon bank balances and from investment of such portion of premium deposits as are not currently required for the payment of losses and expenses are profits earned by an insurance company subject to tax.[1] The subject of reserve funds and the additions thereto which may be deducted from the gross income of insurance companies is treated on page 180 of the 1920 edition under a paragraph headed "Deduction of required addition to reserve

[1] Jewelers Safety Fund Society v. Lowe; Jewelers Safety Fund Society v. Anderson, U. S. Dist. Ct., So. Dist. N. Y., July 19, 1920, T. D. 3078, Treasury Bulletin 44-20-1279.

funds by insurance companies."[2] It was stated in the 1920 edition that a net *decrease* in reserve funds required by law within the taxable year must be included in gross income. This general proposition has been recently approved by the United States Supreme Court.[3] But such a decrease is only taxable if it results in the release to the general uses of the company of the reserves set up with the result that the company's "free assets" are increased. Although the reserves of an insurance company, other than a life insurance company, are generally speaking only a percentage of its surplus which may not be distributed in dividends, the effect is the same as if they were separate and distinct funds. The "unearned premium reserve" is not only a guarantee of payment of the policies against which it is held but also a fund to which resort may, in case of necessity, be made for payment of losses thereunder. If, during the life of any policy, a loss occurs the reserve established for the protection of such policy is released, and to that extent the reserve fund is reduced. If the reserve exceeds the amount of the loss and the policy is not continued in force, the excess becomes part of the general surplus of the company; it is "released to the general uses of the company." If, on the other hand, no loss is incurred by the policy holder, upon the expiration of the policy, the whole amount of the reserve held against it is released to the "general uses of the company" and increases its "free assets." In any case, therefore, in which there is a net decrease in the reserve funds of an insurance company it must first be determined to what extent the reserves thus released have been applied in the payment of the losses against which they are held, and to what extent they exceed the actual losses paid, and are, therefore, released to the "general uses of the company." So much of the released reserve as is applied to the payment of losses never becomes "free assets" of the company, and is not income of the company; but any excess which is released to general surplus thus becoming "free assets" available for any purposes of the

[2] See matter supplementary thereto in present supplement.

[3] Maryland Casualty Co. v. U. S., 251 U. S. 342.

company is income to the company in the year in which it is released, and is to be added to the gross income.[4]

[4] L. O. 1032, Treasury Bulletin 23-20-991.

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Gross Income of Life Insurance Companies. The exact language of the Revenue Act of 1918 in regard to the gross income of life insurance companies is as follows: "In the case of life insurance companies there shall not be included in gross income such portion of any actual premium received from any individual policyholder as is paid back or credited to or treated as an abatement of premium of such policyholder within the taxable year."[1] This language is substantially equivalent to the provision contained in the 1913 law with regard to the gross income of life insurance companies.[2] It has been held by the United States Supreme Court[3] that such provision of the 1913 law requires that purely mutual legal reserve companies issuing level-premium insurance shall include in gross income dividends paid by such companies to any policyholder and *not* applied in payment of a premium. The insurance company in this case contended that the non-inclusion clause of the 1913 law excluded from gross income the aggregate of all dividends paid to any policyholder by credit upon a premium or by abatement of a premium, and also all dividends whatsoever paid to any policyholder in cash, *whether applied in payment of a premium or not.* This contention was overruled by the Supreme Court for the following reasons:

1. Consulting the history of the Act of October 3, 1913, the Supreme Court found that the non-inclusion clause in question

[1] Revenue Act of 1918, Sec. 233 (a)-1.

[2] The provision of the 1913 law was that life insurance companies—both stock and strictly mutual—"shall not include as income in any year such portion of any actual premium received from any individual policyholder as shall have been paid back or credited to such individual policyholder, or treated as an abatement of premium of such individual policyholder, within such year." (Act of October 3, 1913, Section II G (b).)

[3] Penn Mutual Life Insurance Co. v. Lederer, decided by the U. S. Supreme Court on April 19, 1920; T. D. 3046, Treasury Bulletin 33-20-1138. See Sol. Op. 70, Treasury Bulletin 44-20-1280.

was framed to define what amounts involved in dividends should be "non-included" or deductible and thus prevent controversies over questions which had been raised by the Act of August 5, 1909.[4]

2. The contention was made by the insurance company that the nature of all life insurance dividends is the same, whatever the disposition made of them; that Congress could not have intended to relieve life insurance companies from taxation to the extent that dividends are applied in payment of premiums and to tax them to the extent that dividends are not so applied; that Congress must be assumed to have intended, in obedience to the demands of consistency, that all dividends should be treated alike. Disposing of this contention, the Supreme Court held that the differentiation between dividends applied in payment of a premium and those not so applied was entirely consistent, the principle being that of imposing taxation upon *net* premiums instead of *gross* premiums. The Supreme Court held that "there is a striking difference between an aggregate of individual premiums, each reduced by means of dividends, and an aggregate of full premiums from which it is sought to deduct amounts paid out by the company which have no relation whatever to premiums received within the tax year, but which relate to some other premium which may have been received many years earlier." This second contention of the insurance company was also answered by the argument that the motive for taking level-premium life insurance may be mainly protection, but the motive of such insurance is largely that of "savings investment." When the dividend is applied in reduction of the renewal premium, Congress might well regard the element of protection as predominant, and treat the reduction of the premium paid by means of the dividend as merely a lessening of the expense of protection, but after the policy is paid up the element of

[4] See Mutual Benefit Life Insurance Co. v. Herold, 198 Fed. 199, in which the court stated that dividends applied as a reduction on renewal premiums "should not be confused with dividends declared in the case of a full-paid participating holder wherein the policy-holder has no further premium payments to make. *Such payments having been duly made, the policy has become at once a contract of insurance and an investment.*"

investment predominates and Congress might reasonably regard dividends not applied in reduction of the renewal premium as profit on the investment.

3. The contention was made by the insurance company that the juxtaposition of the clauses covering the income of mutual fire and mutual life insurance companies and the provision covering mutual life insurance companies required the application of the same rule to all in regard to returned premiums. The Supreme Court answered this contention with the argument that the three different rules prescribed in three separate clauses for three classes of insurance was conclusive evidence that Congress deliberately intended to differentiate. The purpose of this differentiation was then explained by a consideration of the distinction between mutual fire and mutual marine insurance companies on the one hand, and mutual life insurance companies on the other. The thing for which a fire or marine insurance premium is paid is *protection,* which ceases at the end of the term. If after the end of the term part of the premium is returned, it is not returned as something purchased with the premium, but as a part of the premium which was not required to pay for the protection, that is, the expense was less than estimated. On the other hand, the service performed in level-premium life insurance is both protection *and investment.* Premiums paid have earned so much for the co-operators that the company is able to pay to each not only the agreed amount but also additional sums called dividends, which additional sums have been earned in part, at least, by transactions not among the members but with others, as by lending the money of the co-operators to third persons. The fact that the investment resulting in the accumulation or dividend is made by a co-operative, as distinguished from a capitalistic, concern does not prevent the amount thereof from being deemed a profit on the investment or from being taxable. The failure to differentiate between stock and mutual life insurance companies was not inadvertent. There is a legal difference between stock fire and marine companies and mutual fire and marine companies, but the participating policy commonly issued by a stock life insurance

company is both in rights conferred and in financial results substantially the same as a policy issued by a purely mutual life insurance company. The real difference between the two classes of life companies as now conducted lies in the legal right of electing the directors and officers.

4. Answering the contention of the company that the decision of the court below required the interpolation of the words "within such year" in the statute after the words "any individual policy holder," the Supreme Court held that what the insurance company was seeking was not to have "non-included" a part of the premiums which were actually received within the year or which appeared as a matter of bookkeeping to have been received, but actually were not, but that the company was seeking to have the aggregate of premiums actually received in a year reduced "by an amount which the company paid out within the year, mainly on account of premiums received long before the tax year"; that what the company really sought was "not a non-inclusion of amounts paid in—but the deduction of amounts paid out". The Supreme Court then referred to another provision of the statute prescribing that there might be deducted "the sums other than dividends paid within the year on policy and annuity contracts". This clause was held to be tantamount to a direction that dividends should not be deducted.

In support of the company's contention it was urged that the court should consider the history of the Revenue Act of 1918 and specifically that in that bill, as introduced and passed by the House, the corresponding section[5] contained the words "within the taxable year", and that these words were stricken out by the conference committee.[6] The court held that no aid could be derived from the legislative history of an act passed nearly six years after the one in question. It may be argued that this legislative history of the present statute indicates an intention on the part of Congress to permit dividends of a mutual life insurance company not applied in payment of premiums to be "nonincluded" in gross income. This contention

[5] Revenue Act of 1918, Section 233 (a).

[6] Report No. 1037, 65th Congress.

would seem, however, to be unsound in view of the fact that the Revenue Act of 1918 contains a provision substantially the same as that contained in the 1913 law referred to by the Supreme Court; that is, it provides that insurance companies may deduct "the sums other than dividends paid within the taxable year on policy and annuity contracts".[7] This is apparently the view of the Treasury Department, and it is now held that a life insurance company is not entitled to exclude from its total income during the taxable year, for the purpose of ascertaining its gross income, any dividends paid or credited to policyholders from whom it did not receive any premium during that year; and as to such policyholders as it did receive premiums from that year it is entitled to exclude only such part of the dividends paid to those policyholders as did not exceed the amounts received from them, respectively, by way of premiums during that year.[8]

The term "credited to" is now held to mean "applied by way of credit to the payment of the premium for the taxable year. It does not include dividends applied to purchase additional paid-up insurance or annuities, or to shorten the endowment or premium paying period, or in any way that does not actually reduce the premium-receipts of the company for the taxable year."[9]

The amount of divisible surplus annually ascertained and apportioned to deferred dividend policies is not to be excluded from gross income in computing the net income, for the purpose of taxation, of life insurance companies.

[7] Revenue Act of 1918, Sec. 234 (a) 10.

[8] T. D. 2899, Treasury Bulletin 20-19-514. For the rule under the 1909 Law see Fink v. Northwestern Mutual Life Ins. Co., U. S. Cir. Ct. of Appeals, Seventh Circuit, June, 1920, T. D. 3057, Treasury Bulletin 36-20-1187.

[9] T. D. 3053, Treasury Bulletin 34-20-1153.

[10] Sol. Op. 40, Treasury Bulletin 37-20-1195.

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Deduction of Required Addition to Reserve Funds by Insurance Companies. In the 1920 edition it is stated that a requirement by a State Insurance Commissioner that a net

addition shall be made to certain amounts retained to meet specific liabilities is not a net addition required by law to be made to reserve funds within the meaning of the statute. The case on which this statement was founded[1] has now been modified upon this general point by the United States Supreme Court.[2] The reserves, however, must be required by rules and regulations of State Insurance Departments promulgated in the exercise of an appropriate power conferred by statute.[3] As stated in the 1920 edition, only reserves commonly recognized as reserve funds in insurance accounting are to be taken into consideration in computing the net addition to reserve funds required by law. In the case of a casualty, liability, fidelity, guaranty and surety insurance company recently decided by the United States Supreme Court[4] the term "reserve" has been defined as follows: "* * * A sum of money, variously computed or estimated, which, with accretions from interest, is set aside, 'reserved', as a fund with which to mature or liquidate, either by payment or re-insurance with other companies future unaccrued and contingent claims, and claims accrued, but contingent and indefinite as to amount or time of payment." In the case of the company under consideration a "reserve for unearned premiums", a "special reserve for unpaid liability losses" and a "loss claims reserve" were held to fall within this definition. On the other hand, a reserve

[1] Maryland Casualty Co. v. U. S., 52 Ct. Cls. 201; T. D. 2451.

[2] 251 U. S. 342.

[3] In McCoach v. Insurance Co. of North America, 244 U. S. 585, 37 Sup. Ct. 709, it was held that a reserve required in Pennsylvania to be maintained by a fire and marine insurance company against unpaid losses was not a reserve required by law since it was not required by express statutory provision There is nothing in this case inconsistent with the rule recently laid dow in Maryland Casualty Co. v. U. S., 251 U. S. 342. There was no question in the McCoach case but that under an administrative interpretation of the Pennsylvania statute the reserve was required to be set up; the case turned upon the question whether the reserve was the kind of reserve referred to in the 1909 law. In other words, the case involved a definition of the word "reesrve".

[4] Maryland Casualty Co. v. U. S., 251 U. S. 342. See the definitions of "reserve" in Fink v. Northwestern Mutual Life Ins. Co., June, 1920, U. S. Cir. Ct. of Appeals. Seventh Circuit, T. D. 3057, Treasury Bulletin 36-20-1187.

maintained by the insurance company for "unpaid taxes, salaries, brokerage and re-insurance due other companies" was held not to fall within such definition. The requirements of various states referring to such reserves use the term "reserve" in a non-technical sense and not necessarily in the sense of the 1909 law. It has been held by the Treasury Department that the amount deductible as an addition to reserve funds is the excess of the total reserve fund as required by law at the end of the taxable year over the total of such reserve funds at the beginning of the year regardless of the fact that during the year the reserve funds are increased on account of new business, and decreases in such funds are inevitable when policies mature, lapse, or are surrendered.[5] A life insurance company which maintains a reserve to liquidate coupons left with the company to accumulate at interest and accrued interest thereon is entitled to deduct from gross income in its annual tax returns the net addition made each year to such fund.[6]

The reserves annually set aside by life insurance companies in the State of Nebraska for the protection of deferred dividend policies are reserves required by law in ascertaining whether there has been a net addition to reserve funds deductible in computing the net income subject to tax.[7]

A reserve for the expense of investigating loss claims of an insurance company has been held not to be a "reserve" within the meaning of the 1913 Law and any net addition thereto may not be deducted in determining net income.[8]

Under the 1909 Law it has been held that reserve funds, the net addition to which is to be deducted from the gross income of a life insurance company in computing its net income, are those funds which are built up to mature the policy, and do not include funds reserved because of liabilities on supplementary contracts not involving life contingencies and canceled policies upon which a cash-surrender value may be demanded.[9]

[5] O. D. 427, Treasury Bulletin 13-20-876.

[6] O. D. 799, Treasury Bulletin 1-19-96.

[7] Sol. Op. 40, Treasury Bulletin 37-20-1195.

[8] Sol. Op. 76, Treasury Bulletin 47-20-1315.

[9] Fink v. Northwestern Mutual Life Ins. Co., U. S. Cir. Ct. of Appeals, 7th Circuit, June, 1920, T. D. 3057, Treasury Bulletin 36-20-1187.

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Special Deductions Allowed Mutual Insurance Companies. In determining the amount of premium deposits retained by a mutual fire or mutual casualty insurance company for the payment of losses, expenses and reinsurance reserves, it is to be presumed that losses and expenses have been paid out of earnings and profits, other than premiums, to the extent of such earnings and profits.[1]

[1] L. O. 1050, Treasury Bulletin 40-20-1226, overruling O. D. 403, Treasury Bulletin 7-20-744.

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Footnote 11.

Add:—Jewelers Safety Fund Society v. Lowe; Jewelers Safety Fund Society v. Anderson, U. S. Dist. Ct., So. Dis. N. Y., July 19, 1920, T. D. 3078, Treasury Bulletin 44-20-1279

CHAPTER 12.

FOREIGN CORPORATIONS

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Income From Sources Within the United States. The source, or place of origin, of income is not restricted to the place where payment is made, since such place may be arbitrarily selected without relation to the nature of the transaction and is not indicative of source. Where the income grows out of a business activity in this country, it is immaterial where actual payment is made.[1] Where a Wisconsin partnership and a New York partnership entered into a partnership agreement under which the Wisconsin partnership furnishes 40% of necessary capital and has exclusive control of purchasing, handling, storing and shipping of Wisconsin tobacco, and the New York firm furnish 60% of the capital and has exclusive control of the sale and disposition of the tobacco, all sales being made without the State of Wisconsin, the portion of the income going to the New York firm has been held under the Wisconsin Income Tax Law to be income derived partly from property and business within the State of Wisconsin and partly from business transacted without the State, which should be allocated.[2]

The Attorney General has recently rendered an opinion on the question of what constitutes income from sources within the United States in the following five specific cases:

1. A corporation organized under the laws of Scotland owns and operates two sawmills in the United States. The mills saw logs into plank squares called "handle blanks" and also roughly turn hammer handles. These products are all exported to Glasgow, where they are finished at the home mill. In addition the manager of the American plant buys logs in the United States and exports them as such to Great

[1] O. D. 651, Treasury Bulletin 35-20-1174.

[2] Village of Westby v. Bekkedal (Wis.), 178 N. W. 451.

Britain. No part of the products of the mills located in this country or of the logs purchased here is sold in the United States, but the entire output is sold in Great Britain. The plants and operations of the manager in the United States are conducted solely from funds sent to this country from the home office in Glasgow, Scotland, and no funds are sent to the home office from the American plants. No income is derived from the mere manufacture of goods; before there can be income there must be sale; and there is no income from sources within the United States from goods manufactured here unless there is, in the language of the statute, "both manufacture and disposition of goods within the United States." The obvious purpose of this section is to tax only income that accrues within the United States. Congress does not attempt to tax profits arising from goods manufactured in this country but sold after being shipped abroad and without being disposed of by the owner in this country. When the corporation manufacturers or partially manufacturers articles in this country but does not sell or dispose of them until they are taken to Scotland, there is no income from sources within the United States. As to the purchase and exportation of logs, since profits that may accrue from such transactions are not specifically provided for in the section of the statute taxing profits on the "manufacture and disposition of goods within the United States," they are taxable, if at all, because they represent compensation from trades, businesses, commerce, etc., as enumerated in another section[4], which are carried on within the United States. For the reasons given in cases quoted from in the footnote below[5] it is concluded that income which may accrue to the corporation in England by sale of logs purchased in the United States is not income from sources within the United States.

[3] Revenue Act of 1918, § 233 (b).

[4] Revenue Act of 1918, § 213 (a).

[5] In Sulley v. Attorney General. 5 H. & N. 711 (2 Br. Tax Cas. 149), under a statute taxing the income of nonresidents "from any property whatever in the United Kingdom, or profession, trade, employment, or vocation exercised within the United Kingdom," the facts are similar to those above stated. Sulley was a partner in a firm of general merchants

and drapers carrying on business in both the United States and England. Sulley resided in England and the other petitioners in the United States. Sulley transacted the business of the firm in England, which sonsisted of purchasing goods in England and shipping them to the United States. No money was received in England except what was sent from the United States, and the profits of the business were made by the resale of goods at an increased price in the United States. The court held that the liability to income tax attached only to such profits as came home to England as the share of Sulley, the partner resident there. The Lord Chief Justice said:

"The question is, whether there is a carrying on or exercise of the trade in this country. I think there is not, looking at the sense in which the term is used and having regard to the subject-matter of the statute. Wherever a merchant is established, in the course of his operations his dealings must extend over various places; he buys in one place and sells in another. But he has one principal place in which he may be said to trade, viz., where his profits come home to him. That is where he exercises his trade. It would be very inconvenient if this were otherwise. If a man were liable to income tax in every country in which his agents are established, it would lead to great injustice. The argument for the Crown must be carried to this extent, that merely buying goods in this country is a trade exercised here so as to subject the purchaser of the goods to income tax. In the present case the defendant is a partner; but if the argument is well founded, this American firm might be taxed in the same way if he had been merely an agent. It would be most impolitic thus to tax those who come here as customers. The subject of a foreign State, not resident here, can not be made amenable to our laws. How then are their profits to be made amenable to the fiscal law? Simply by the provision that whosoever carries on the business and receives the profits here shall be assessed. But in the present case no profits are received by the firm, or exist in this country. * * * The profits of the firm in America do not accrue in respect of any trade carried on in this country, but in respect of the trade carried on in New York, where the main business is conducted."

In State ex rel. Manitowoc Gas Co. v. Wisconsin Tax Commission, 161 Wis. 111, the Supreme Court of Wisconsin said: "If an income be taxed, the recipient thereof must be domiciled within the State, or the property or business out of which the income issues must be situate within the State so that the income may be said to have a situs therein."

2. The second case involved an English corporation acting through a New York corporation. Under an agreement between them the latter corporation is granted the exclusive right to handle the merchandise of the former in the United States and Canada. Orders for the goods are taken by the New York corporation on net terms, payment to be made 10

days after delivery. A minimum net price for the sale of the goods by the New York corporation is fixed by the English corporation at an amount not to exceed the price obtained for similar goods in England. The New York corporation assumes credit risks and advances 50% of the minimum net price against the bills of lading or packers receipts. The amount advanced is deducted by it, together with freight charges, commissions, etc., when remitting to the English corporation the amounts collected from the customers. The New York corporation receives a 5% commission on the sale of the goods and any excess over the minimum net price, after deducting such commission, and charges for freight, duties, insurance, etc., are shared equally between the two corporations. No price that is insufficient to cover the minimum net price, plus freight, duty, and other charges, is accepted without the approval of the English corporation. The latter accepts all merchandise risks. If goods are refused or returned to the New York corporation by its customers, it is required to make every effort to dispose of them. Unless goods are sold at a profit above all expenses, the New York corporation receives no commission thereon. The goods are covered by insurance for the joint account of both corporations and are invoiced to the customer by the New York corporation. This case is the converse of the situation in 1, above. The English corporation in this case purchases goods in England and sells them within the United States, and profits accruing from such transactions are plainly profits derived from business carried on within the United States[6]. The gross income from such business is income from sources within the United States and is to be estimated in the same way that such income is estimated where both manufacture and sale are had within the United States.

3. The third case involves a partnership organized in England, consisting of two members who are citizens and residents of that country. The principal office of the firm is at Liverpool, England, but it maintains an office at Dallas, Texas,

[6] See Werle & Co. v. Colquhoun, 2 Br. Tax Cas. 402; Turner v. Rickman, 4 Br. Tax Cas. 25; MacPherson & Co. v. Moore, 6 Br. Tax Cas. 107.

which is operated under a somewhat similar name. The Dallas office is in charge of a manager, who receives a fixed salary and a stipulated commission based upon the net earnings of the firm in accordance with a contract of employment made by him with the members of the firm. The business of the firm is that of cotton merchants and importers. The branch office is engaged in buying cotton in the United States in behalf of the firm and in shipping it to the parent office in England for disposition. It is the custom of the branch office to draw on the parent office for amounts sufficient to make such purchases, together with a liberal margin to cover estimated charges and expenses, so that at the end of the season the branch office may show a balance to its credit. The branch office does not make any sales. It was held that the firm is not deriving income from sources within the United States.

4. The fourth case is that of a partnership organized in England consisting of six members, five of whom are British subjects residing in London and the other a citizen of the United States residing in New York. The home office of the firm is in London, but it maintains a branch office in New York City in charge of and conducted under the name of the partner resident in that city. The business of the firm is that of commission merchant in raw furs. The furs are consigned to it from various parts of the world, including the United States, the sales being made almost entirely in London at auction by auctioneers employed by the firm or at private sale. The firm does not at any time take title to the goods, but title remains in the consignor until the sale, when it passes to the purchaser. The principal function of the New York office is to solicit consignments of raw furs to the firm at London, which requires the resident partner to travel to various points in the United States and Canada. The majority of goods consigned from Canada are sent to New York for shipment to London. The New York office also acts as disbursing agent for the firm in paying to consignors in the United States and Canada the proceeds of sales of their goods in London, attends to the shipment of the goods to London, and their storage and insurance in New York while waiting for steamers,

and further makes advances to consignors on the security of bills of lading or express receipts. The money required to maintain the New York office is obtained by selling drafts on London, and a balance of about $20,000 is usually carried by it with a New York bank. The income of the partnership is derived from a commission of about 6% on the proceeds of sales from furs consigned to it. It collects the proceeds of the sales and deducts its commission, the expenses, if any, incurred by it for freight, insurance, or storage, and also the amount of any advances made to the consignors. The balance of the proceeds is remitted to the consignors. No profit is made on the freight or other charges. It has been held that only the income of the partner resident within the United States is taxable.

5. In the fifth case a corporation organized under the laws of Great Britain, with its home office at Manchester, England, operates a line of freight steamships between Philadelphia, Pa., and foreign ports. The corporation has no office in the United States, but consigns its steamships to a corporation at Philadelphia, who handles them as agents and brokers, together with steamships consigned to them by other owners. The agents see to the entry and clearance of each steamer and the discharge and loading of the cargo and supplies, collect such part of the freight as is prepayable in this country for the ocean carriage, deduct the amount of the agents' disbursements and charges for their services, and remit the balance to the steamship corporation at Manchester upon the departure of the vessel. Frequently a large part of the freight is not prepayable, but is payable upon delivery of the goods at Manchester. In an opinion[7] rendered by the Attorney General under the 1909 Law it was decided that foreign steamship companies engaged in the business of transporting passengers, goods, and merchandise between ports in the United States and foreign ports, and maintaining passenger and freight agencies in this country were taxable under that act. The Attorney General said:

[7] 28 Op. A. G. dated March 9, 1910.

[8] Erickson v. Last, 8 Q. B. D. 414 (4 Br. Tax Cas. 422).

"* * * Their business consists entirely in transporting passengers and goods and merchandise between ports in this country and those of foreign countries, and receiving and discharging the same. Through agents located here all contracts and arrangements incident to such a business at this end of their lines are made, and all exports are delivered to their warehouses and loaded upon their vessels, and the passengers embark, while they are within the limits of the United States; and likewise here their imports are unloaded and passengers from foreign ports disembark. If these companies do not transact business in the United States they transact no business in any foreign port, and their entire business is carried on upon the high seas. To such a conclusion I am unable to give assent." A similar conclusion was arrived at in an English case which held that a cable corporation established at Copenhagen, with an agent and an office in London, with cables extending between England and Denmark, was carrying on trade in England from which profit arose on account of contracts entered into with persons in England to send messages from England to other countries. Brett, L. J., said:

" * * * That which earns the profit, as I said at first, or that out of which they get the profit is the better phrase, is the money to be paid to them out of the contract, which contract is made in England, and such contracts being habitually made by them in England, it seems to me, they carry on in England the trade or business of making such contracts. Therefore, it seems to me, that these people are properly said to be persons from whom this duty must be collected." It was held that the English corporation derives income from sources within the United States to the extent that it derives income from freight and passenger traffic originating within the United States[9].

[9] Op. A. G. dated November 3, 1920.

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FOREIGN CORPORATIONS MANUFACTURING AND DISPOSING OF GOODS IN THIS COUNTRY. The share of profits of a foreign

corporation under an arrangement with a domestic corporation whereby the latter purchased goods from the former at a minimum price for resale in the United States, the domestic coporation receiving a commission in the event of resale in excess of the minimum price, and the balance of the excess (after the deduction of certain expenses) being divided between the two corporations, represents income from sources within the United States.[1]

[1] O D. 384, Treasury Bulletin 4-20-708.

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SALE OF GOODS BY CORRESPONDENCE. The mere selling of raw materials in this country by a foreign corporation through the medium of a mail-order business or unsolicited orders, does not constitute transacting business within the United States and any income received from such transactions would not be subject to tax.[1]

[1] O. D. 294. Treasury Bulletin 23-19-549.

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FOREIGN CORPORATIONS HAVING NO OFFICE OR AGENT IN THIS COUNTRY, COLLECTING COMMISSIONS. Amounts paid to a non-resident foreign corporation not having an office or place of business in the United States as compensation for orders secured by it from foreign customers for exports booked through such non-resident foreign corporation are held not to be income from sources within the United States.[1]

[1] O. D. 112, Treasury Bulletin 2-19-167.

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PURCHASE AND SALE OF BANK ACCEPTANCES. Where a nonresident foreign corporation purchases through an agent in this country bank acceptances at a certain rate of discount and sells such acceptances through that agent or some other agent, for a price greater than the price for which purchased, the amount of income received as a result of the transaction represents income from sources within the United States.[1]

[1] O. D. 221, Treasury Bulletin 11-19-387.

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FOREIGN STEAMSHIP COMPANIES. When freight shipments, originating in Canada are brought to a United States port by railroad, are received at that port by a foreign steamship company (which does business and maintains a regular agency in the United States) for transportation abroad, and the freight charges of the steamship company are prepaid by the railroad company; and the company's vessels, upon their return voyage to the United States, use coal purchased abroad as ballast, which is sold upon arrival in the United States, the freight charges on the goods transported abroad represent income from sources in the United States. The amount received for the ballast coal disposed of in the United States should also be included in gross income, and the cost of such coal to the company should be claimed as a deduction. This matter should appear as a separate transaction in the supplementary statements filed with the company's return.[1]

[1] O. D. 596, Treasury Bulletin 29-20-1077.

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FOREIGN INSURANCE COMPANIES. Foreign insurance companies which have agents or brokers in this country soliciting insurance and collecting premiums for them are doing business within the United States, and any income received from such sources is income from sources within the United States.[1]

[1] O. D. 586, Treasury Bulletin 28-20-1062.

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Footnote 34.

Add:—O. D. 651, Treasury Bulletin 35-20-1174.

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Footnote 38.

Towne v. Eisner, 245 U. S. 418, 38 Sup. Ct. 158.

[Page 198.]

Foreign Governments. It is held that a foreign government is not subject to tax on income derived from the operation of vessels owned by such government through its agents in the United States. Neither is the foreign government liable

to tax upon the income arising from the operation for its benefit of vessels chartered by it.[1]

A subject of a foreign country, who at the time of his appointment to a legation in the United States is a resident of the United States, would be subject to tax on the same basis as a citizen of the United States.[2]

The provision which exempts from income tax certain income of foreign ambassadors, ministers, and their subordinates who were nonresident aliens at the time of appointment does not extend to income received by their wives from sources within the United States.[3]

Delegates to the United States representing a foreign country in connection with an agreement with the United States Food Administration, whereby flour is furnished to that country, and raw materials are brought to this country and sold, would not be subject to tax with respect to any profits derived from the sale of such products.[4]

Only foreign diplomats, ambassadors, and other diplomatic representatives in charge who are accredited to the United States to represent their sovereign or country and who reside in the United States, and the members of their staff, are entitled to exemption from tax on income from investments in bonds and stocks and from interest on bank balances. Foreign consuls resident in the United States are not entitled to the exemption.[5]

Residents of the United States, as well as citizens thereof, are subject to tax with respect to any income received which represents compensation for services rendered to a foreign legation.[6]

The Commonwealth Bank of Australia was established by an act of the legislature of Australia, which provided that the appointment of the governor of the bank and the control of

[1] O. D. 515, Treasury Bulletin 21-20-951.
[2] O. D. 196, Treasury Bulletin 9-19-339.
[3] O. D. 153, Treasury Bulletin 5-19-248.
[4] O. D. 182, Treasury Bulletin 8-19-315.
[5] O. D. 336, Treasury Bulletin 29-19-624.
[6] O. D. 196, Treasury Bulletin 9-19-339.

its affairs should be vested in officials of the Government; that the capital necessary for its operations should be supplied solely by the sale of interest-bearing obligations, not entitling the purchaser thereof to any interest in the bank or to any share in its profits, the issuance and sale of which are to be controlled by the Governor General of the Commonwealth; that the securities so issued are guaranteed by the Commonwealth; that the Commonwealth is exclusively entitled to any profits of the bank and is the guarantor of its debts. The bank is therefore a governmental agency of the Commonwealth of Australia and as such is exempt from income tax.[7]

Interest credited by a domestic bank to the account of a foreign bank, part of whose stock is owned by a foreign Government, is not exempt from income tax.[8]

Interest on funds of foreign legations deposited in banks in the United States is not subject to income tax.[9]

[7] O. D. 628, Treasury Bulletin 33-20-1129.
[8] O. D. 448, Treasury Bulletin 15-20-844.
[9] O. D. 710, Treasury Bulletin 24-20-1275.

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Footnote 40.

Add.—O. D. 483, Treasury Bulletin 18-20-895; O. D. 20, Treasury Bulletin 1-19-32.

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LOSSES. A foreign corporation doing business in the United States, having a taxable year falling within the period beginning after October 31, 1918, and ending prior to January 1, 1920, and sustaining a "net loss" during such taxable year, such net loss being attributable to its operations in the United States, is entitled to have such net loss deducted from its income for the preceding taxable year and the income and excess-profits taxes for such preceding taxable year redetermined. If the net loss is in excess of the net income for such preceding taxable year the amount of such excess is to be allowed as a deduction in computing the net income for the succeeding taxable year.[1]

[1] O. D. 611, Treasury Bulletin 31-20-1099. The subject of "net losses" is treated more fully on page 388 of the 1920 edition.

CHAPTER 13.

EXEMPT ORGANIZATIONS

[Page 209.]

Where Question as to Right of Exemption Exists. The character of a corporation must be judged by its articles of incorporation, constitution, and by-laws rather than by the declarations of its officers or the method by which it conducts or has conducted its business.[1]

[1] O. D. 190, Treasury Bulletin 8-19-328. But see A. R. R. 218, Treasury Bulletin 32-20-1121. A distinction is made as to religious, charitable, scientific and educational corporations. See A. R. R. 219, Treasury Bulletin 32-20-1121, as to such corporations.

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Labor, Agricultural and Horticultural Organizations (first class). The following kinds of organization have been held not to fall within this class of exempt organizations:

1. An activity organized for the purpose of affording employment to members of a labor union, which, although owned and controlled by the union, is not a part of the union as such, wages being paid to members employed and profits after paying expenses being turned into the treasury of the union.[1]

2. Organizations for the publication of a breed register the purpose of which is to render a service to the breeders of pure bred live stock.[2]

[1] O. D. 523, Treasury Bulletin 21-20-961.

[2] A. R. M. 79, Treasury Bulletin 33-20-1137. Many of these organizations are very profitable, and while they utilize a portion of their profits for the advancement of the breeds which they register, through prizes and premiums offered for such breeds at the various agricultural fairs, thereby advancing their own interests as well as those of the breeders, they do pay dividends out of what remains. Such organizations might be so organized and operated as to fall under the sixth or seventh class described below.

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Mutual Savings Banks (second class). A savings fund association having no capital stock represented by shares and deriving its entire income from investments of deposits, such income being divided *pro rata* among all members after deducting operating expenses, the members (who are required to be depositors) electing the board of trustees from their number and these trustees electing officers, is exempt.[1]

An association of employees of a company formed for the purpose of enabling its members to save and borrow money, the members of which are limited to the employees of the company who elect annually a board of trustees, has been held exempt under this heading. Each member of this association might subscribe to from 1 to 25 shares of stock which is represented by certificates of deposit, and at the end of the year the money paid in, together with the earnings thereon, was returnable to the members proportionately, but each member had the option of allowing the money to remain on deposit to accumulate further earnings. Any member might borrow from the association on his promissory note, but in no greater amount than remained to his credit, plus a sum equal to one month's salary, unless the note was secured by satisfactory collateral.[2]

[1] O. D. 528, Treasury Bulletin 22-20-974.
[2] O. D. 703, Treasury Bulletin 43-20-1265.

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Fraternal Beneficiary Societies (third class). A fraternal beneficiary society is a society whose members have adopted the same or a very similar calling, avocation, or profession, or who are working in unison to accomplish some worthy object, and who for that reason have bound themselves together as an association or society to aid and assist one another and to promote the common cause. The term "fraternal" can properly be applied to such an association for the reason that the pursuit of a common object usually has a tendency to create a brotherly feeling among those who are thus engaged. The absence of profit in the operation of such an association is not

the criterion as to whether it is within the exemption as a fraternal beneficiary society, but the want of a fraternal side or object which it is in some manner organized to promote. A fraternal beneficiary association may be a mutual insurance company, but must be something more. It must be primarily fraternal and must be operated under the lodge system or for the exclusive benefit of the members of a fraternity itself operating under the lodge system. A society whose single purpose was to write insurance only for members of a certain religious sect who might pass a satisfactory medical examination, and which extended the privilege of insurance to members living apart from their fellows, has been held not to be a fraternity of communicants of a certain sect, but a mutual insurance company writing only such communicants.[1]

An incorporated society operating under the lodge system throughout the United States, its charter providing for the union of eligible members into a grand fraternal, beneficiary, educational and patriotic society, assessments being levied upon its members to provide for the payment of sick and death benefits, for disability relief in case of accident and for promoting their social, moral, educational and patriotic advancement, the society deriving income from subscriptions to a daily and a weekly newspaper as well as from job printing and other sources, none of the income inuring to the benefit of any private stockholder or individual, has fraternal and benevolent features, but it is chiefly a patriotic organization interested in the general welfare of its members and its powers are so extensive as to preclude its classification as a fraternal beneficiary society.[2]

A travelers' association providing for fixed death benefits to the beneficiaries of the members is held to be a mutual life insurance association rather than a fraternal beneficial society. The law provides no exemption for mutual associations of this character.[3]

[1] O. D. 690, Treasury Bulletin 42-20-1250.
[2] O. D. 508, Treasury Bulletin 20-20-940.
[3] O. D. 63, Treasury Bulletin 1-19-88.

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Domestic Building and Loan Associations and Co-Operative Banks (fourth class). When a building and loan association is otherwise exempt, it will not ordinarily be subject to tax because:

(a) It has paid-up shares which are (1) preferred as to earnings, and (2) have a definite rate of interest which may be higher than the rate of dividends paid on other stock;[1] or

(b) Its balance sheets show that it is lending considerable sums to nonmembers;[2] or

(c) It is a regular borrower of large sums which it uses for loans to members, the dues paid by members being inadequate for the business transacted by it.[3]

Where a building and loan association has an amount of paid-up capital which is so large as to be entirely out of proportion to the amount of running shares on which members are paying, it may or may not be liable to income tax, the liability to tax of such an institution depending upon the facts of the particular case.[4]

A building and loan association, whose capital stock is represented by 6,000 paid up shares as against 1,600 running shares, and 30,000 fully paid investment certificates as against 8,000 installment certificates, is not entitled to exemption.[5]

[1] Park View Building & Loan Assn. v. Herold, 203 Fed. 876, 210 Fed. 577; T. D. 1941. This was not true under the 1909 Law. (See Footnote 24, page 213, of 1920 edition.)

[2] Central Building, Loan & Savings Co. v. Bowland and Bellefontaine Building & Loan Co. v. McMaken, 216 Fed. 526. This also was not true under the 1909 Law (see Footnote 24, page 213, of 1920 edition).

[3] Bellefontaine Building & Loan Co. v. McMaken, 216 Fed. 526.

[4] S. 1140, Treasury Bulletin 19-19-499.

[5] O. D. 573, Treasury Bulletin 27-20-1043.

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Religious, Charitable, Scientific and Educational Corporations (sixth class). The courts favor tax exemptions which pertain to charitable, religious, or educational institutions upon the theory that such institutions relieve burdens of the Gov-

ernment.[1] The term "organized", as used in the provision granting exemption to this class of corporations, refers to the real substance and intent of the organization, and not to its mere form, the charter and by-laws merely giving rise to presumptions which may be affirmed or rebutted by extraneous evidence.[2] The word "private" refers to a stockholder or individual in his private capacity as distinguished from a public capacity. Dividends inure to a stockholder in his private capacity when they inure to him separate from the public and not as an official or representative of the public.[3] The term "charitable" has been given a very broad meaning by the courts, but it is noticeable that the decisions applying the broadest meaning are in cases involving "charitable uses", that is, where there is a trust for a charitable purpose. It is, of course, expedient to uphold such trusts where a construction of the law will possibly admit it.[4] Education, in a broad sense and with reference to man, comprehends all that disciplines and enlightens the understanding, corrects the temper, cultivates the taste, and forms the manners and habits.[5] It is the process of developing and training the powers and capabilities of human individuals.[6] The prime purpose of education is to benefit the individual.[7] On the other hand, the primary purpose of propaganda is much more narrow. Propaganda is that which propagates the tenets or principles of a particular doctrine by zealous dissemination.[8] It is a matter of common knowledge that propaganda in the popular sense is disseminated not primarily to benefit the individual at whom it is directed, but to accomplish the purpose or purposes of the person instigating it. This is a very material difference. The Solicitor of the Treasury Department is of the opinion that it was Congress' intention, when providing for the deduction of

[1] O. D. 510, Treasury Bulletin 20-20-942; Congregational Church Society v. Board (Ill.), 125 N. E. 7.
[2] A. R. R. 219, Treasury Bulletin 32-20-1121.
[3] T. B. R. 33, Treasury Bulletin 8-19-329.
[4] S. 1246, Treasury Bulletin 8-20-755.
[5] Century Dictionary, p. 1845.
[6] Mt. Herman Boys' School v. Gill (Mass.), 13 N. E. 354, 357.
[7] Century Dictionary, p. 1845.
[8] Century Dictionary, p. 4774.

contributions to educational corporations, not to benefit and assist the aims of one class against another, not to encourage the dissemination of ideas in support of one doctrine as opposed to another, to the profit of one class and to the detriment perhaps of another, but to foster education in its true and broadest sense, thereby advancing the interest of all, over the objection of none.[9]

The following types of organization are exempt under this class:

1. A branch of the Y. W. C. A., established for the purpose of marketing the needlework of self-supporting women, which pays to the producers the full selling price of the goods sold, less a certain commission which only partially defrays the running expenses of the enterprise, the deficit being derived from income of the Y. W. C. A. and from voluntary contributions;[10]

2. An organization incorporated for the purpose of establishing and maintaining a day nursery for young children whose parents are obliged to work and have no means to provide care for their children during the day, and deriving its income from subscriptions and donations, and a small amount from securities, all of which is used in promoting the activities of the nursery;[11]

3. An incorporated publishing house, without capital stock, owned and controlled by a religious denomination, its business consisting strictly of printing religious publications in the form of books, tracts, Sunday-school lessons, catalogues, periodicals, etc., and distributing them to the various branches of the church and members of congregations, no business being done for the general public;[12]

[9] S. 1362, Treasury Bulletin 22-20-971.

[10] O. D. 509, Treasury Bulletin 20-20-941.

[11] O. D. 340, Treasury Bulletin 29-19-630.

[12] O. D. 510, Treasury Bulletin 20-20-942. It was clear that the predominant purpose of the publishing house involved in this decision was to advance the cause of Christianity. It was conducted at a profit, none of the income inured to the benefit of any private individual, being paid over in its entirety to the treasurer of the church for the exclusive benefit of the church.

4. An organization such as the Teachers' Insurance and Annuity Association of America, which though in form a business insurance company was required to adopt this form in order to issue non-participating policies under the laws of New York;[13]

5. A corporation organized and operated for the purpose of preventing the employment of children in injurious occupations.[14]

The following types of organizations are not exempt under this class:

1. An actively operating railroad which turns over all of its income to a charitable institution as a dividend;[15]

2. A corporation conducting an educational institution all of whose stockholders are directors in the company, and which pays dividends to its stockholders, the surplus earnings over a fixed rate paid as dividends being invested as they accrue in grounds, buildings, and equipment needed in the business;[16]

3. An incorporated educational institution whose only source of income is from tuition and sale of uniforms and supplies to its students, and no part of the net income of which is distributed as dividends, but is expended in acquiring additional buildings and equipment, is not entitled to exemption, the corporation being considered as capitalizing its earnings by acquiring new buildings and equipment;[17]

4. A corporation organized for the purpose of acquiring and holding title to land and erecting thereon suitable buildings for conducting an assembly or chautauqua, religious, educational, and recreational in character, deriving income from ground rentals, sales of tickets, advertising space, hotel accommodations, etc., all expenditures being made in connection with hiring talent and entertainment and the upkeep of buildings and grounds, none of the income of which is paid to any

[13] A. R. R. 218, Treasury Bulletin 32-20-1121.
[14] O. D. 705, Treasury Bulletin 43-20-1267.
[15] O. D. 60, Treasury Bulletin 1-19-85.
[16] T. B. R. 33, Treasury Bulletin 8-19-329.
[17] O. D. 293, Treasury Bulletin 23-19-548.

stockholder or individual, although the charter and by-laws do not prohibit such payment.[18]

5. A corporation organized and operated exclusively for the purpose of erecting and maintaining monuments or other like memorials no part of the earnings of which inures to the benefit of any private stockholder or individual.[19]

6. An association organized and operated for the purpose of furthering the enactment of prohibition laws, the selection of prohibition officials, and the nomination and election of political candidates favorable to its work.[20]

[18] A. R. M. 36, Treasury Bulletin 11-20-786. If the corporation involved in this decision should have gone out of existence, the stockholders would have benefited directly through the distribution of the assets, as well as through any appreciation of such assets.

[19] S. 1246, Treasury Bulletin 8-20-755. The status of such corporations as have additional purposes involving a positive dissemination of knowledge will be determined on proper facts submitted in each case.

[20] O. D. 703, Treasury Bulletin 43-20-1266.

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Business Associations (seventh class). A corporation organized for the purpose of fostering, developing and promoting scientifically a certain industry, with no capital stock represented by shares and not authorized to invest funds for profit or to make any distribution thereof by way of dividends, the funds for maintaining the association being derived solely from assessments against individual member firms and dues with the exception of interest on bank deposits and Liberty bonds purchased from excess surplus funds, which in accordance with the by-laws are required to be refunded proportionately to those contributing the funds, no other securities being owned by the association, and the interest on the Liberty bonds not being credited or distributed to any member, is exempt.[1]

An unincorporated association formed for the purpose of ascertaining the causes of losses sustained through navigation of vessels belonging to its members, thereby reducing such losses, any excess of fees, assessments, and interest received

[1] O. D. 522, Treasury Bulletin 21-20-960.

over current expenses and losses sustained by members being returned to members on a *pro rata* basis, is exempt.[2]

[2] O. D. 61, Treasury Bulletin 1-19-86.

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Clubs (ninth class). A provision in the by-laws of a country club, that, in the event of dissolution, the holder of a life membership shall participate in the distribution of the assets of the club after its other debts are paid and before any sums are paid to either regular members or shareholders, is not alone sufficient to make the club liable to tax.[1]

A club formed for the purpose of providing for the members thereof a suitable meeting place, a library, and a dining room where meals will be furnished to the members, the income being derived from membership dues and the receipts for food, wine, and cigars purchased by members, and no part of the net earnings inuring to the private benefit of any member, is entitled to exemption from taxation.[2]

A club organized for the purpose of promoting the principles and interests of a certain political party, deriving its income from membership dues and donations which are used for the purpose of defraying expenses necessary to the operation and upkeep of its rooms, no part of which inures to the benefit of any of its members, is exempt.[3]

An automobile club organized for the purpose of promoting the improvement of roads and boulevards, and other matters of benefit to automobile owners and drivers, such as sign-posting roads and securing legislation of benefit to automobile owners and drivers, its income being derived from membership fees and subscriptions, no part of which inures to the benefit of any private stockholder or individual, is exempt.[4]

[1] S. 958, Treasury Bulletin 1-19-81.
[2] O. D. 108, Treasury Bulletin 2-19-162.
[3] O. D. 280, Treasury Bulletin 20-19-513.
[4] O. D. 643, Treasury Bulletin 34-20-1152.

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Mutual or Co-Operative Organizations of a Purely Local Character (tenth class). An association is not "of a purely

local character" when its business activities are not confined to a particular community, place, or district. The business operations of such a "like organization" might be confined to a particular community, place, or district, thus bringing it within the meaning of the words "purely local character," and yet cover portions of more than one State. The words "purely local character" imply a single locality, irrespective of political subdivisions. But when its activities cover half the counties of two States, and part of two other States, such districts being two or three hundred miles apart; or when its activities cover a whole State and part of another State, they are of "general" rather than of "local" character and the associations are not exempt from taxation.[1]

An insurance association incorporated under the laws of a certain State for the purpose of permitting automobile owners to exchange contracts of insurance and indemnity without becoming jointly liable as subscribers on any risks, confining its activities within the State and its only source of income being from assessments, dues, and fees collected from members for the sole purpose of meeting expenses, is a "like organization of a purely local character."[2]

A reciprocal indemnity exchange incorporated by a number of manufacturers to insure their businesses against fire loss on the reciprocal and interinsurance plan through an attorney in fact, having the power to issue policies, collect premiums, and adjust losses, the business of which is not conducted for profit, and the contract of insurance or power of attorney signed by each member providing that there shall be no capital stock or joint funds, but that each subscriber shall act individually and shall deposit a fixed amount to meet losses, any balance being returnable at the end of the period of insurance, falls within this class of exempt organizations.[3]

Where a casualty insurance association is organized for the purpose of insuring its members throughout the State, and not within a geographical subdivision thereof, and where it issues

[1] O. 792, Treasury Bulletin 1-19-82.

[2] O. D. 312, Treasury Bulletin 25-19-586.

[3] O. D. 538, Treasury Bulletin 23-20-989.

policies of insurance for stipulated cash premums instead of depending upon assessments solely for the payment of its insurance liabilities, and where its annual surplus over all expenditures, losses, etc., may be returned to the members in the shape of annual dividends, and where the fund for the payment of salaries and other operating expenses is a large percentage of cash received by it, and it makes permanent investments of large amounts in Liberty bonds of the United States, the association cannot be considered exempt.[4]

A mutual irrigating ditch company providing for its expenses by assessment against its stockholders and receiving no other income except certain rents derived from the use of its surplus water is not exempt since its income does not consist solely of assessments, dues, and fees collected from members.[5]

A mutual liability insurance company deriving its income from premiums and assessments of its members which are used to defray operating expenses and to indemnify its policyholders against amounts which they are required to pay under a workmen's compensation law, is not exempt.[6]

[4] O. 790, Treasury Bulletin 1-19-83.

[5] O. D. 318, Treasury Bulletin 26-19-594.

[6] O. D. 252, Treasury Bulletin 14-19-437.

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Associations for Marketing Product (eleventh class). A co-operative creamery company which buys outright the products of its members and distributes the proceeds on the basis of the number of shares held by each member instead of on the basis of the quantity of milk or butter fat in the milk furnished by such members, is not exempt.[1] An incorporated fruit growers' union, which conducts its business at a profit, thereby accumulating a fund out of which dividends are paid, is deprived of exemption from tax if it allows persons who are not fruit growers to acquire stock and thus share in the profits. To the extent that it has such stockholders it loses its character as sales agent acting for the mutual benefit of the fruit growers, and accordingly its exemption from tax also. The union

[1] O. D. 191, Treasury Bulletin 8-19-330.

may, however, deduct from gross income amounts periodically returned to members as a refund of profits on business transacted with them and proportioned to the amount of such business.[2] A corporation organized to act as sales agent for farmers and having a capital stock on which it pays a fixed dividend amounting to the legal rate of interest, and all of the capital stock of which is owned by such farmers, is exempt from tax.[3]

[2] O. D. 64, Treasury Bulletin 1-19-89.
[3] Sol. Op. 57, Treasury Bulletin 35-20-1172.

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Footnote 36.
Add:—S. 952, Treasury Bulletin 1-19-84.

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Corporations Owned by Exempt Corporations (twelfth class). A corporation managed by five trustees, operating a theater building erected as a memorial, the net income from which is to be turned over to a city, for its use and benefit, is not one organized for the "exclusive purpose of holding title to property, collecting income therefrom, and turning over the entire amount thereof less expenses to an organization which itself is exempt from income tax."[1] A co-operative store managed by a university for the purpose of selling to its students supplies of every kind, and in case of dissolution its property reverting to the trustees of the school, does not come within the class of corporations organized for the exclusive purpose of holding title of property, collecting income therefrom, and turning over the entire amount thereof. It is actively engaged in the operation of a business in which profits are realized.[2]

[1] O. D. 177, Treasury Bulletin 7-19-300.
[2] O. D. 65, Treasury Bulletin 1-19-90.

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Joint-Stock Land Banks. Joint-stock land banks are not exempt under the present law.[1]

[1] Sol. Op. 68, Treasury Bulletin 41-20-1235.

CHAPTER 14.

INCOME IN GENERAL

[Page 222.]

What Constitutes Income. An able English jurist has held in effect that annual income is either a conventional figure or a mere approximation. Income must be a thing sufficiently real to be capable of being taken out of a business by its owners without impairment of capital. The exact point at which an impairment of capital begins is one that cannot easily be determined with precision, and questions of doubt as between income and capital must be resolved in favor of capital. In a very real sense losses may be admitted, while profits must be proved. Capital once impaired is gone, but the admission of a loss not fully realized by a complete transaction results in nothing more serious than a postponement of profit to a subsequent period. The imposition of an income tax in effect compels a withdrawal of a portion of the income from the business, and the tax is imposed ratably upon all net income, so that if through an error in computation a stated figure of income includes any amount of capital the tax is imposed not upon income but upon capital.[1]

[1] T. B. R. 48, Treasury Bulletin 16-19-457.

[Page 223.]

Footnote 6.

Add:—See Eliasberg Bros. Mercantile Co. v. Grimes (Ala.), 86 So. 56.

[Page 224.]

Footnote 12.

Add:—Fink v. N. W. Mutual Life Ins. Co., June, 1920, U. S. C. C. A. 7th Cir., T. D. 3057, Treasury Bulletin 36-20-1187.

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BOOKKEEPING ENTRIES. No taxable income accrues to a public utility corporation from a mere book entry charging construction account and crediting income account due to charging interest on the company's own funds used temporarily for construction purposes, as permitted under the Interstate Commerce Commission's classification.[1]

[1] O. D. 246, Treasury Bulletin 13-19-425. Neither will the company be allowed to include in its assets such amount of interest charged to capital account for the purpose of determining invested capital.

When the officers of a corporation upon the sale of their capital stock in the corporation to another corporation agree not to engage in a similar business for a certain period within the United States, any part of the consideration in fact payable to the other employees of the corporation for the purpose of securing their goodwill is not income to the officers even though the agreement of sale of the stock makes no mention of this collateral arrangement. It must, however, be satisfactorily established that by written or oral understanding such part of the consideration was not for the benefit of the officers.[2]

Since an unrecorded assignment of an oil and gas lease under the laws of Oklahoma, executed in good faith and actually delivered, passes title, funds coming into the hands of the assignor thereafter are held by him in trust for the benefit of the assignee.[3]

[2] A. R. M. 56, Treasury Bulletin, 23-20-984.

[3] Sol. Op. 59, Treasury Bulletin 38-20-1201.

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Footnote 17.

The case of Maryland Casualty Co. v. U. S., 52 Ct. Cls. 201, has now been modified by the Supreme Court (see 251 U. S. 342) but the principle involved in the citation in this footnote has been upheld. The case of Fink v. Northwestern Mutual Life Ins. Co., U. S. Cir. Ct. of Appeals, Seventh Circuit June, 1920, T. D. 3057, Treasury Bulletin 36-20-1187, sustains the principle stated in the 1920 edition over this footnote. See also Lumber Mut. Fire Ins. Co. v. Malley, 256 Fed. 380.

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Income Actually Received. A discussion of the subject of when items of income should be included in gross income will be found elsewhere in this book.[1]

[1] See supplement to Chapter 33.

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EXAMPLES OF CONSTRUCTIVE RECEIPT. The donation by assignment of partnership profits to be earned in the future does not exempt such profits, when determined, from taxation as a part of the individual income of the donor.[1]

[1] O. 912. Treasury Bulletin 20-19-505.

[Page 229.]

Footnote 30.

The case of Maryland Casualty Co. v. U. S., 52 Ct. Cls. 201, has now been modified by the Supreme Court (see 251 U. S. 342) but the principle involved in the citation in this footnote has been upheld.

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INCOME FROM FOREIGN COUNTRIES. Income should be returned for the purpose of Federal taxes in terms of United States money. The rate of exchange at the time of receipt governs in making the computation.[1] The net profits of a

[1] O. D. 419, Treasury Bulletin 13-20-805. The following rates have been accepted as the current or market rates of exchange prevailing as of December 31, 1919:

London	3.765	(dollars to £ sterling)
Australia	3.80	(dollars to £ sterling)
New Zealand	3.80	(dollars to £ sterling)
Paris	10.85	(francs to dollars)
Belgium	10.80	(francs to dollars)
Milan	13.25	(lire to dollars)
Madrid	.1925	(cents to peseta)
Stockholm	.2140	(cents to kroner)
Christiania	.2020	(cents to krone)
Copenhagen	.1910	(cents to krone)
Amsterdam	.37375	(cents to guilder)
Buenos Aires	1.01375	(pesos to dollars)
Montevideo	.95	(centavos to dollars)
Rio de Janeiro	.28	(cents to gold milreis)
Lima	4.74	(dollars to Peruvian £)
Mexico City	.50375	(cents to pesos)
Manila	.485	(cents to pesos)
Calcutta	.4525	(cents to rupee)
Singapore	.54	(cents to Singapore dollars)
Germany	.0203	(cents to marks)
Poland	.0092	(cents to marks)
Austria	.006	(cents to kroner)
Czecho-Slovakia	.0175	(cents to kroner)
Jugo-Slavia	.009	(cents to kroner)
Greece	.1490	(cents to drachma)
Roumania	.0290	(cents to leu)
Bulgaria	.0230	(cents to lev)
Serbia	.0430	(cents to dinar)
Finland	.0310	(cents to markka)

(O. D. 551, Treasury Bulletin 25-20-1010.)

foreign branch of a domestic corporation, which keeps a separate set of books in foreign currency and renders a report at the end of the year as to the profits, and which remits amounts to the home office from time to time when it has more money on hand than it needs, should be computed in foreign currency. From the total profits for the year should be subtracted the total amount remitted to the home office during the year, all expressed in foreign currency. To determine the equivalent of the profits in terms of United States money, the amounts remitted should be converted at the rate of exchange in effect at the date such remittances were made. The balance of the net profits, expressed in foreign currency, should be converted at the rate as of the end of the taxable year, regardless of the fact that the profits may not have been remitted to the home office.[2] A taxpayer purchasing goods from a foreign country, the value of such goods being quoted in terms of the foreign currency, should enter the cost thereof at the current or market rate of exchange prevailing at the time payment for the goods is actually made.[3] A domestic corporation which bought its raw material from foreign stockholders, making credit and debit entries first in francs and then in dollars at the rate of exchange prevailing at the date of each transaction, which corporation on closing its books converted the entire balance due into dollars at the rate as of the closing of the taxable year, has been held to have incorrectly reported income, since the method used resulted in the returning of unrealized gain or loss due to changes in the rate of exchange,—a gain or loss which could never be realized (except upon liquidation) until the debit due the foreign interests was repaid. It was held that in order to reflect true net income, all amounts either debited or credited to the account of the foreign interests should be entered on the books in dollars at the rate of exchange prevailing at the date of the transaction. It was held

[2] O. D. 550, Treasury Bulletin 25-20-1009; O. D. 489, Treasury Bulletin 19-20-909; O. D. 618, Treasury Bulletin 31-20-1109. This ruling leaves unsettled the question of gain or loss arising from a difference, if any, between the rate of exchange at the end of the year and the date or dates when the balance at the end of the year is remitted.

[3] O. D. 489, Treasury Bulletin 19-20-909.

that any net debit at the end of a taxable year should be applied to the portion of the debt to the foreign interests longest outstanding; that any gain or loss arising from the difference in the rate of exchange prevailing at the time the obligation was incurred and the rate prevailing at the time the obligation is retired should be accounted for, the rate prevailing at the time the obligation is retired to be the average rate of exchange per dollar as ascertained by applying to each debit item against the foreign interests during such succeeding year the rate of exchange prevailing at the time each such debit item was created.[4] The franc values might thereafter be disregarded. In the case of taxpayers trading or manufacturing in foreign countries the Committee has reached the conclusion that under the abnormal conditions characterizing foreign exchange during the European war, current assets less current liabilities payable in the foreign currency may be converted at the current rate of exchange or at any rate less favorable to the taxpayer. The Commissioner will consider applications to adopt a rate more favorable to the taxpayer or may on his own motion apply such a rate where the facts in the particular case warrant such departure. This ruling has no reference to isolated or collateral investments in foreign credits or securities.[5]

[4] O. D. 590, Treasury Bulletin 29-20-1069. This ruling criticises the method employed by the company as productive of artificial and unrealized gain or loss arising from changes in the rate of exchange, yet the method proposed seems open to the same criticism. The ruling ignores the well-established accounting practice that current assets and liabilities should be converted at the rate of exchange current on the date of the balance sheet. (See Kester—"Accounting Theory and Practice"—1918, Vol. II, page 547; Dickinson—"Accounting Practice and Precedure", pages 125-6; Dawson—"The Accountant's 'Compendium'", pages 529-530; Cutworth—"Treatment of Fluctuating Currency in Accounts", page 10.)

[5] A. R. R. 15, Treasury Bulletin 3-20-682.

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Footnote 35.

The case of Maryland Casualty Co. v. U. S., 52 Ct. Cls. 201, has now been modified by the Supreme Court (see 251 U. S. 342) but the principle involved in the citation in this footnote has been upheld.

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Income Received in the Form of Notes. When a corporation keeping its accounts on the basis of actual receipts and disbursements, loans money secured by first mortgage bonds and receives as commission second mortgages on the property of the borrower payable without interest in 5 or 10 annual installments, such second mortgage notes are held to be income at their fair discounted value as of the date of receipt. If the notes are not marketable at a fair discount, each installment payment should be included in gross income in its entirety in the year in which received.[1]

[1] O. D. 728, Treasury Bulletin 46-20-1302.

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Exempt Income. Rentals derived from the leasing of a railroad constructed and owned in common by certain townships and a county are income derived from a public utility and are exempt from income tax. The leased railroad must, however, file a return of income.[1] When a corporation is organized to furnish water, light, power and heat to a town, the town owning practically all the common stock, which is not dividend bearing, the preferred stock to be redeemed as soon as possible out of earnings, after which the plant becomes the property of the town, the income of the corporation from the operation of its plant is exempt from income tax, since the imposition of a tax would delay the redemption of the preferred stock, thereby imposing "a loss or burden" on the town. The corporation must, however, file a return of income.[2]

[1] O. D. 250, Treasury Bulletin 14-19-434.
[2] O. D. 328, Treasury Bulletin 28-19-612.

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Footnote 47.

Add:—T. B. R. 32, Treasury Bulletin 6-19-270.

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INCOME OF STATES. In general, income accruing to any State, Territory or possession of the United States, or to any political subdivision thereof, is exempt from tax.[1]

Where property is willed to a municipality in trust that the income of the property shall be used for a public charity the income is not liable to tax and the trustees of the fund are not required to file annual returns.[2]

[1] Reg. 45, Art. 84; Cooley on Taxation, Vol. I, p. 153; Ward v. Maryland, 12 Wall. 418; Collector v. Day, 11 Wall. 113; U. S. v. Railroad Co., 17 Wall. 322; S. 1374, Treasury Bulletin 18-20-896.

[2] O. 895, Treasury Bulletin 14-19-433.

CHAPTER 15.

INCOME FROM PERSONAL SERVICES

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Salaries. Where a company sets apart on its books at the end of one year a lump sum representing a part of its net profits for that year for the purpose of distribution to its employees as additional compensation for that year, the actual disbursement of the fund being made in the early part of the next year, such additional compensation is not income for the earlier year unless actually made available to the employees and is not constructively received by the employees in the earlier year.[1] An individual, keeping his books on a cash receipts and disbursements basis, who performed services in 1909 under an agreement that he was to receive as compensation a percentage of the net income of an enterprise, the time of payment to be within the discretion of the individuals controlling the enterprise, is not taxable with respect to such compensation until 1919, if the compensation is not paid until that year, even though the amount thereof was determined in 1916. His taxable income consists of the difference between the amount received and the value of his claim on March 1, 1913.[2]

If the compensation of a Federal official has been withheld for a number of years pending settlement of a contested election, and it is paid to him after a decision has been rendered in his favor, the entire amount should be reported as income of the year in which received.[3]

Commissions advanced in payment for services of an advertising solicitor should be reported as gross income for the taxable year in which received. Any portion of the commissions

[1] A. R. R. 182, Treasury Bulletin 29-20-1070.

[2] O. D. 717, Treasury Bulletin 45-20-1289, superseding O. D. 460, Treasury Bulletin 16-20-858.

[3] O. D. 432, Treasury Bulletin 14-20-824.

thus received, which are paid back, owing to failure of payment for advertising, may be deducted as a loss for the year in which payments are returned.[4]

It is held that a taxpayer who had been discharged from the employ of a railroad company and, after being reinstated by order of the Railroad Board, paid for all time lost during a period of over two years, should return the amount so received as income for the year in which paid. The payment cannot be treated as a gift since it was not made voluntarily.[5]

[4] O. D. 19, Treasury Bulletin 1-19-31.
[5] O. D. 512, Treasury Bulletin 21-20-948.

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Bonuses and Profit-Sharing. Bonuses paid by a corporation partly in cash and partly in stock of the corporation, which stock was purchased by the corporation on the open market, in accordance with a plan laid down by its board of directors, to the most deserving of its employees (which must be recognized as meaning most deserving on account of services rendered); represent additional compensation to the employees and as such are deductible by the corporation and taxable to the recipients. The fact that the corporation did not deduct the amount representing these bonuses from gross income in its return would not affect the taxability of the bonuses in the hands of the employees. The amount to be considered as taxable income is the actual amount of cash, plus the market value of the stock, when received by the employees.[1] A bonus paid by a State to its residents who served in the military or naval forces during the war with Germany does not constitute taxable income to the recipient.[2] Where an individual is employed as an agent for a firm and under his contract is to receive as compensation 50% of the profits of the agency which may be appropriated by him monthly as earned, the amount actually appropriated constitutes income of the agent for the year in which appropriated.[3]

[1] O. D. 570, Treasury Bulletin 27-20-1039.
[2] O. D. 286, Treasury Bulletin 22-19-533.
[3] S. 1312, Treasury Bulletin 7-20-738.

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Rewards. A reward for the performance of a special service, such as prevention of a bank robbery, constitutes taxable income.[1]

[1] O. D. 602, Treasury Bulletin 30-20-1088.

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Footnote 14.

Add:—T. D. 2992, amending Reg. 45, Art. 33.

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Voluntary Offerings Received by Clergymen. A clergyman is not liable to tax on amounts received by him during the year from his parish, provided that he turns over to the religious order of which he is a member all moneys received in excess of his actual living expenses on account of the vow of poverty which he has taken. Members of religious orders are subject to tax upon income received individually but are not subject to tax upon income received merely as agents of the orders of which they are members.[1]

[1] O. D. 119, Treasury Bulletin 3-19-180.

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Supper Money. "Supper money" paid to an employee for voluntary performance of extra labor after regular business hours, such payment not being regarded as additional compensation nor charged to the salary account, is paid for the convenience of the employer and is not taxable income to the employee.[1]

[1] O. D. 514, Treasury Bulletin 21-20-950.

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Footnote 16.

Add:—T. D. 2992, amending Reg. 45, Art. 33; O. D. 265, Treasury Bulletin 18-19-475.

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INSURANCE PREMIUMS PAID FOR EMPLOYEES. Premiums paid by an employer on policies of group life insurance covering the lives of employees, the beneficiaries of which are not

designated by the employees, are not income to such employees. The financial benefits under such policies do not move to the employees personally but only to their heirs or dependents after their deaths, and the payment of the policies is in any case contingent upon the employee's continuance until death in the employment of his present employer, which employment may be terminated at any time by himself or his employer. The payment is also contingent upon continued payment of premiums by the employer. The employee has no option to take the amount of the premiums paid for the policy covering his life instead of the insurance. The policies have no paid-up value either to the employer or to the employee. Such insurance creates no debt on the part of the employer, pays no debt to the employee, and discharges no legal obligations resting upon the employee. The only benefit obtained by the employee himself is a feeling of contentment that provision has been made for his dependents, and the payment constitutes an investment on the part of the employer in increased efficiency. The same considerations apply to cases in which a portion of the premiums for group life insurance is paid by associations of employees, provided no contract covering such payment exists between the employer and the employees.[1]

[1] T. D. 2992, amending Reg. 45, Art. 33, published in Treasury Bulletin 13-28-19; O. 1014, Treasury Bulletin 12-20-793.

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Footnote 18.

Add:—O. D. 627, Treasury Bulletin 33-20-1128.

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Footnote 20.

Add:—T. D. 2992, amending Reg. 45, Art. 33; O. D. 570, Treasury Bulletin 27-20-1039.

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Services Rendered Prior to March 1, 1913. An executor is entitled, under the laws of New York, to one-half of his commission for receiving the estate of the deceased, and one-half

for paying it out. In the case of commissions received subsequent to March 1, 1913, in an estate received prior to that date, one-half is in satisfaction of a claim which vested prior to March 1, 1913, and is a return of capital to the extent of its market value on that date.[1]

[1] A. R. R. 321, Treasury Bulletin 47-20-1311.

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Compensation for Services Extending Over a Year. A taxpayer who keeps no books of account, and to whom is paid upon the termination of services extending over a period of years, a lump sum in amount not previously agreed upon, as compensation for such services, must return as income in the year in which received the entire amount so paid him, even when such payment is accompanied by a statement proportioning the compensation over the years in which the services were rendered.[1] Where the compensation of a receiver, trustee, or similar fiduciary is awarded or paid at the conclusion of the trust, it is presumed, in the absence of satisfactory evidence to the contrary, that it did not accrue during the course of the trust, and it is accordingly taxable as income of the year when awarded or paid. Where it is understood at the beginning of the trust that the amount of the compensation is not to be determined until its conclusion, and this understanding is adhered to during the course of the trust and no payments are made on account of such compensation, this presumption becomes conclusive.[2]

[1] Jackson v. Smietanka, U. S. Dist. Ct., E. Div., N. Dist. Ill., December, 1919; T. D. 2960, Treasury Bulletin 3-20-683; State ex rel. Houghton v. Phelps (Wis.), 176 N. W. 217.

[2] T. B. R. 12, Treasury Bulletin 3-19-178.

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Compensation to Federal Government Officers and Employees. Compensation received by Federal Reserve Agents and their assistants, as well as other employees of Federal Reserve Banks, is subject to tax.[1]

[1] O. D. 15, Treasury Bulletin 1-19-27.

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REIMBURSEMENT FOR ACTUAL EXPENSES. If expended solely in connection with their official duties and if no part of the same is diverted for personal use, any expense money received by Naval Attaches to be expended for entertaining and exceptional purposes in connection with their duties, is not subject to tax.[1]

[1] O. D. 36, Treasury Bulletin 1-19-48.

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Compensation of Soldiers and Sailors. The following compensation is not within the exemption of $3,500, accorded to persons in active service in the military or naval forces of the United States:

1. Compensation received by persons serving in the American Merchant Marine Sea Training Bureau;[1]
2. Retainer pay received by Naval Reservists while on inactive duty;[2]
3. Compensation received by persons in the Army Transport Service;[3]
4. Compensation received by persons in the military service from the Spruce Division;[4]
5. Compensation received from the War Department by a civilian flying instructor;[5]
6. Compensation of the employees of the Commission on Training Camp Activities;[6]
7. Compensation received by an officer of the National Guard detailed to the General Staff College;[7]
8. Compensation received by employees of the Knights of Columbus War Activities;[8]
9. Compensation received by persons in the military or

[1] O. D. 329, Treasury Bulletin 28-19-613.
[2] O. D. 463, Treasury Bulletin 16-20-860.
[3] O. D. 462, Treasury Bulletin 16-28-59.
[4] O. D. 214, Treasury Bulletin 11-19-376.
[5] O. D. 122, Treasury Bulletin 3-19-183.
[6] O. D. 27, Treasury Bulletin 1-19-39.
[7] O. D. 435, Treasury Bulletin 14-20-828.
[8] O. D. 485, Treasury Bulletin 18-20-898.

naval forces for services between April 6, 1917, and December 31, 1917;[9] and

10. Compensation received by the personnel of the United States Merchant Marine enrolled in accordance with rules and regulations of the Shipping Board.[10]

The following compensation is within the exemption of $3,500 accorded to persons in active service in the military or naval forces of the United States:

1. Compensation of the personnel of the Public Health Service;[11] and

2. Compensation of Army Field Clerks.[12]

The following items are to be included in the $3,500 exemption:

(a) Bonus payable upon discharge;

(b) Mileage from point of discharge to point of enlistment, and

(c) Ration money covering the periods of absence from camp on furlough.[13]

The personal exemption allowed married men and the exemption for dependents are not included in the $3,500 exemption.[14]

[9] O. D. 337, Treasury Bulletin 29-19-625.

[10] O. D. 663, Treasury Bulletin 38-20-1202.

[11] O. D. 495, Treasury Bulletin 19-20-915.

[12] O. D. 435, Treasury Bulletin 14-20-827. The right to the $3,500 exemption in the case of "reconstruction aids" in the army is dependent upon their status, whether military or civil, while engaged in such work. The exemption would not be allowed in the case of a civilian so engaged, whereas it would be allowed in the case of a member of the military forces under similar assignment without change of status. (O. D. 435, Treasury Bulletin 14-20-827.)

[13] O. D. 370, Treasury Bulletin 3-20-686.

[14] O. D. 123, Treasury Bulletin 3-19-184.

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Compensation of Federal Judges. In a recent case it has been held that that provision of the Revenue Act of 1918 tax-

ing the salaries of Federal judges is unconstitutional.[1] It has been held by the Treasury Department that the compensation of Federal judges appointed after the passage of the Revenue Act of 1918 is subject to tax.[2]

[1] Evans v. Gore, decided by the United States Supreme Court, June 1, 1920. The Treasury Department has ruled that this case is not applicable to referees in bankruptcy and that the fees received by such referees are subject to tax. (O. D. 678, Treasury Bulletin 41-20-1229.)

[2] T. D. 3049, Treasury Bulletin 33-20-1127.

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Compensation of the President of the United States. In a recent decision of the United States Supreme Court, which in reality presented the question whether the provision of the Revenue Act of 1918 taxing the salaries of Federal judges was constitutional, it has been clearly indicated that the provision taxing the salary of the President of the United States is unconstitutional.[1] The salaries of presidents elected after the passage of the Revenue Act of 1918 will be held taxable.[2]

[1] Evans v. Gore, decided by the United States Supreme Court, June 1, 1920.

[2] T. D. 3049, Treasury Bulletin 33-20-1127.

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Compensation of Officers and Employees of a State or Political Subdivision Thereof. The following are officers or employees of a State or political subdivision thereof within the meaning of exemption granted to the compensation of such officers and employees by the Treasury Department (but not by the Revenue Act of 1918):

1. Persons serving on the jury of a State, county, or municipal court;[1]

2. A chief engineer appointed by a Sewerage Commission created by the Common Council of a State under authority of a State statute;[2]

3. A referee in drainage appointed by the District Judge of a State judicial district in which the drainage project is loca-

[1] O. D. 434, Treasury Bulletin 14-20-826.

[2] O. D. 309, Treasury Bulletin 25-19-582.

ted, such Judge being vested with authority to provide for the payment of the referee's salary, to regulate his duties, and to discharge him at pleasure;[3]

4. A county surveyor who is paid from county funds even though on a *per diem* basis;[4]

5. Members of the Virginia Debt Commission;[5] and

6. The attorney for the State Comptroller appointed under the New York Transfer (Inheritance) Tax Law to look after the State's interests in the collection of inheritance taxes; such attorney receiving as compensation a commission on the transfer of most of the estates and in some cases such fees and allowances as the State Comptroller deems reasonable and proper.[6]

The following are not officers or employees of a State or political subdivision thereof within the meaning of exemption granted to the compensation of such officers and employees:

1. Trustees of a corporation who have filed an application for winding up the affairs of the corporation in accordance with the laws of Connecticut, such trustees not being receivers in fact and not exercising a public function under an appointment of the court;[7]

2. Administrators and executors;[8]

3. An individual who exercises a public function under an appointment issued by a court officer for a particular transaction or purpose for a limited time and who in the exercise of such function is not vested with the character of either an officer or employee of the State or political subdivision thereof;[9]

4. Witnesses summoned by a State Attorney (as to fees).;[10]

5. Clerical assistants employed by the Clerks of State

[3] O. D. 525, Treasury Bulletin 22-20-968.
[4] O. D. 33, Treasury Bulletin 1-19-45.
[5] O. D. 257, Treasury Bulletin 16-19-460.
[6] O. D. 494, Treasury Bulletin 19-20-14.
[7] O. D. 369, Treasury Bulletin 3-20-685. The compensation of such trustees is fixed by the court.
[8] O. D. 256, Treasury Bulletin 16-19-459.
[9] O. D. 256, Treasury Bulletin 16-19-459.
[10] O. D. 195, Treasury Bulletin 9-19-338.

courts in connection with the administration of the Federal Naturalization Laws and paid out of fees collected by the State Court Clerks;[11]

6. Individuals employed in constructing a causeway and paid from the funds of three railway companies and a county which is part owner of the project;[12]

7. Individuals holding the positions of "State Agent of Normal Schools for Whites," "State Agent of Normal Schools for Negroes," and "High School Inspector," which positions are created by the Superintendent of Public Instruction of a State without statutory authority;[13] and

8. A partnership of civil engineers employed by a State irrigation district to serve as consulting and supervisory engineers in connection with the development of the irrigation district under a contract prescribing a stipulated payment per annum in addition to expenses and for all time in excess of 60 days in any one year, a certain sum per day in addition to expenses, and under which contract the engineering work in connection with the irrigation district is to be performed under the general direction of the partnership.[14]

When a receiver is appointed by a State Court for the assets of a corporation, part of which are located in the State appointing the receiver and the remainder in another State, the Federal District Court for the latter State appointing the same person as receiver for the assets located in that State, and the fees from the receivership are allowed in a lump sum, the exemption accorded to compensation received by an officer of a State or political subdivision thereof applies only to that

[11] O. D. 484, Treasury Bulletin 18-20-897.

[12] O. D. 553, Treasury Bulletin 25-20-1013.

[13] O. D. 449, Treasury Bulletin 15-20-845.

[14] O. D. 545, Treasury Bulletin 24-20-1001. The partnership in this case had similar contracts with other districts and counties and accepted business from the public in general. The work was not subject to the direction and control of the directors of the irrigation district, but its relation to the directors was similar to the relation between an attorney and a client who pays an annual retainer for any legal services the client may require.

portion of the fee of such receiver attributable to his appointment by the State Court.[15]

Salaries paid to teachers are exempt only where the educational institution is maintained wholly by the State and the relation of employer and employee exists between the State and the teacher. They are not exempt merely because the teachers are engaged in educational work, nor because they are pensioned by the State.[16]

Pensions received from the State or a political subdivision thereof by retired employees are exempt.[17]

Compensation paid by a State or political subdivision thereof to its officers and employees is exempt even though the recipient be a non-resident alien.[18]

The compensation of teachers of the Territory of Hawaii is subject to tax.[19]

[15] O. D. 503, Treasury Bulletin 20-20-933.
[16] O. D. 826, Treasury Bulletin 4-19-214.
[17] O. D. 434, Treasury Bulletin 14-20-826.
[18] O. D. 274, Treasury Bulletin 19-19-497.
[19] O. D. 12, Treasury Bulletin 1-19-24.

CHAPTER 16.

INCOME FROM BUSINESS, TRADE OR COMMERCE.

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Inventory. Where a taxpayer manufactures property and keeps it on hand for a number of years, until it is sold in the taxable year 1918, the gain derived is the difference between the selling price and the cost, if acquired after February 28, 1913, or if acquired prior to March 1, 1913, the fair market value as of that date; or the difference between the selling price and the inventory value of the goods at the beginning of the taxable year, on the inventory basis regularly followed by the taxpayer; that is, either an inventory basis of cost or an inventory basis of cost or market value, whichever is lower. It is not permissible to use market value except when it becomes material in taking inventory on the basis of cost or market value, whichever is lower.[1]

Where a taxpayer takes inventories on the basis of cost or market price, whichever is lower, goods which were acquired before March 1, 1913, will be inventoried at the market value on March 1, 1913, or at the market price at the time of the inventory, whichever is lower.[2]

[1] S. 926, Treasury Bulletin 1-19-10. In this case the taxpayer was taxed in 1918 on an appreciation in value occurring gradually over several years merely because the sale occurred in 1918. The case illustrates the effect of the limitation of inventories to (a) cost, or (b) cost or market, whichever is lower, to be as follows:. 1 A gradual appreciation in value may not be prorated over the years of appreciation because inventories may not be taken at market if market is higher than cost; 2 A gradual depreciation in value may be prorated over the years of depreciation because inventories may be taken at market if market is lower than cost.

[2] S. 1003, Treasury Bulletin 5-19-245.

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NEED OF INVENTORIES. The delivery of copper bullion to a smelting and refining company where it is mixed with other

bullion and concentrates of different metallic contents under a contract by which the smelting and refining company is to return the equivalent of the metallic contents of such ore previously determined by assay, less commissions and other allowable charges, constitutes a sale and not a bailment. Only so much of the metals as had been redelivered by the refining company at the close of the taxable year belonged to and should have been included in the inventory of the taxpayer as of that date.[1]

Where in 1919 an American corporation advanced a sum of money to an English corporation for the purpose of enabling the English corporation to purchase raw material to manufacture certain articles which the American corporation had contracted to sell for the English corporation and at the time the American corporation took its inventory, December 1, 1919, the articles had not been received by it, such advance to the English corporation was considered a loan, and the value of the claim could not be inventoried at its depreciated value owing to the decline in exchange.[2]

The net income of a person engaged in the business of propagation and culture of oysters can not be properly computed upon the basis of inventories.[3]

[1] S. 1373, Treasury Bulletin 20-20-930. The general rule is that when by the terms of the contract under which property is delivered by an owner to another, the latter is under no obligation to return the specific property either in its identical form or in some other form in which its identity may be traced, but is authorized to substitute something else in its place, either money or some other equivalent, the transaction is not a bailment, but is a sale or exchange. (Austin v. Seligman, 18 Fed. 519; Powder Co. v. Burkhardt, 97 U. S. 110; Woodward v. Semans, 125 Ind. 330, 25 N. E. 444; Buffum v. Merry, 4 Fed. Cas. 2112.)

[2] O. D. 541, Treasury Bulletin 24-20-994.

[3] O. D. 684, Treasury Bulletin 42-20-1240.

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VALUATION OF INVENTORIES. The valuation of inventories on the basis of average cost[1] or average of market prices ex-

[1] T. B. R. 48, Treasury Bulletin 16-19-457.

tending over a period of years[2] is not permitted by statute. The average cost method may be briefly described as follows: Materials purchased during the month are added both as to quantity and cost to the quantity and cost balance brought forward from the previous month, and an average cost at the close of the month is computed by dividing the total quantity into the total money figures. This average is then applied to the quantity of material used for manufacture during the month, and the amount so computed is credited to the material account.

The starting point in the computation of annual income must be the sales made during the year. It is the profits or losses upon these sales that are to be computed if any actuality is to be attained. To do otherwise is to invite speculation and confusion. To give annual profits and losses meaning and integrity they must be arrived at by a logical computation which recognizes that each year acquires from its predecessor certain potentialities and turns over to the successor the property as it exists at the end of the year, and the basis of valuation at the beginning and end of the year must be reasonably uniform. If the starting point in the computation of annual profit or loss is the sales made during the period, the next step is the computation of the amount that is to be charged against such sales in respect of the cost of the goods that have gone into the sales. This must include (1) the cost of the goods included in the sales, less any portion of such cost which may have in effect, through a previous inventory based upon a market lower than cost, been charged against the sales of a previous year, and (2) where as a consistent policy inventories are taken upon the basis of market when it is less than cost, such further amount, if any, as may be required to reduce the goods in the inventory to the level of a lower present market. To charge against the sales of a year a sum less than the total found under (1) and (2) above will show as profits an amount larger than the profits actually realized upon the sales of the period. In a business requiring goods to be carried for lengthy periods and where an average

[2] T. B. M. 31, Treasury Bulletin 6-19-269.

method of inventory valuation is used, this overstatement of profits will occur whenever the current market is declining, while on an advancing market the profits on the actual sales of the year will be understated. When the market is stable the average method will reflect with approximate accuracy the true profits, and in a business in which the turnover is rapid, the effect of such a method upon the computation of annual income is small as compared with a business in which it is necessary to carry goods, such as raw materials, for long periods. In such cases, so long as the annual profits are stated with substantial accuracy, taxpayers should not be required to make inventory changes which are annoying to them and which are without commensurate importance to the Government. The average cost method of inventorying may, however, have an important effect upon taxation. The computation of net income upon such a basis results in an assignment of income to a year, not upon the basis of the transactions of the year, but upon the basis of transactions part of which spread over more than a year. To be strictly logical, such a method should, moreover, include a similar averaging of sales. This would tend toward uniformity of annual profits and might, in fact, reflect the profits as accurately as the partial average method, but it would be a far departure from an actual computation. An annual accounting period is a fundamental requirement, and every computation of taxable net income must be made in conformity therewith. This the average cost inventory method fails to do, and its use cannot be approved as meeting the statutory requirement.[3]

Neither are the "base stock," "minimum" or "cushion" methods of taking inventory permitted by the statute. According to the base stock method of taking inventories a manufacturer or dealer values at the same price year after year the minimum quantity of goods which he must have on

[3] T. B. R. 48, Treasury Bulletin 16-19-457. A monthly average cost method has been permitted in the case of tobacco companies taking inventories by that method, no other method approaching theoretical accuracy being practicably possible. (A. R. R. 18, Treasury Bulletin 3-20-680.)

hand at all times. This base stock method has not been sanctioned as an established accounting practice by the test of general acceptation or the test of time. The present income tax system is based upon an annual accounting period. The object of an inventory is to assign to an annual accounting period its profits and losses. The effect of the base stock inventory method is to assign all profits and losses in respect of the minimum inventory to the year in which such inventory is liquidated. This result is accomplished through ignoring sales and exchanges of individual items of the inventory and treating the minimum inventory as a unit. Each sale or exchange of property for other property having a market value is, however, in fact a realization of taxable profit or deductible loss in the year in which it occurs and a method of accounting which disregards such realization does not truly reflect income.

The usual practice and general object of the basic method is to get the base or constant stock at a figure below cost and hold it there. It arises not from a desire to measure capital and net income accurately, but to play safe, stabilize profits, and provide reserves against possible future losses. It is a result of essentially the same policy and theory which leads bankers to write down their buildings to a nominal figure and to accumulate hidden reserves.

In substance the base stock inventory results in offsetting an inventory gain of one year against an inventory loss of another rather than in assigning to each year its true gain or loss. The fact that the Revenue Act of 1918 in its provisions with respect to inventory loss and net loss authorizes in some cases the carrying of a loss realized in one year into accounts of another year is some indication that Congress did not intend that the ordinary inventory provisions should be construed to authorize such a transfer. Furthermore, the argument that the application of the ordinary rules as to inventories results in hardship is met by the fact that Congress has authorized relief against hardship through the

medium of these inventory and net loss provisions in cases which are within the terms thereof.[4]

The general conclusion that the base stock method does not conform to the requirements of the Revenue Act of 1918 applies to "goods taken in the inventory which have been so intermingled that they cannot be identified with specific invoices." Such goods will be deemed to be the goods most recently purchased. This presumption or inference is warranted because in the absence of evidence as to the actual fact it is more nearly true than any other. Goods taken in the inventory which have been so intermingled that they cannot be identified with specific invoices will not be deemed to be the goods included in the minimum inventory.

In lieu of the base stock method, it has been suggested to the Advisory Tax Board that inventories be valued on a moving average basis for a period of five years, more or less. According to this method one-fifth, for example, of the inventory would be deemed to be the goods most recently purchased and the balance the goods on hand at the beginning of the year. Another method proposed was that the goods in the inventory be deemed to be the earliest rather than the latest purchases. These methods have been held open to the same objections as the base stock method.[5]

If the actual accrued charges which must eventually be paid by a taxpayer, either directly or indirectly through credits to ustomers, can be accurately determined and applied to the goods actually in stock at any specified date, such charges if set on the books as an existing liability, form proper additions to the cost price of the goods then on hand; but this additional value must be determined by charges actually paid or to be paid and cannot be arrived at by the application of any empirical formula and cannot include interest, except on money

[4] T. B. R. 65, Treasury Bulletin 22-19-531. The British Committee on Financial Risks attaching to the holding of Trading Stocks, after an investigation and analysis of this subject, decided against the base stock method in a report submitted December 5, 1918.

[5] T. B. R. 65, Treasury Bulletin 22-19-531.

actually borrowed for the purpose of carrying the goods, nor any appreciation in value of the goods.[6]

Liquor dealers were not permitted to omit from inventory as at December 31, 1919, stocks of liquor then on hand with the understanding that if the liquor was subsequently disposed of for value the total value received would be returned as income of the year in which the disposition was made.[7]

When request is made for permission to change from cost or market, whichever is lower, to cost for pricing inventories at the close of 1919, the permission will be granted since it will have no effect on the tax if market was above cost at the close of 1918, and will increase the tax if market was lower than cost at that date. The permission will, of course, be upon the condition that the new method be followed consistently thereafter. Under the tax laws prior to the Revenue Act of 1918, no specific reference was made to inventories, but under the regulations inventories were required to be taken at cost for every year until December 19, 1917.[8] As this date was only a few days prior to the end of the calendar year 1917, probably few taxpayers took advantage of the option to inventory at cost or market, whichever was lower, in making their 1917 return. The Revenue Act of 1918 specifically granted authority to provide for the taking of inventories on any basis consistent with sound commercial practices and which would reflect true income, and the Regulations issued under that law authorized a change to cost or market, whichever was lower. In many lines of industry, however, market was above cost and inventories were consequently priced at cost. Where it can be shown that the market at the close of 1918 or 1919 was above cost the taxpayer may now elect to take his inventory upon a cost or market basis, whichever is

[6] A. R. R. 140, Treasury Bulletin 23-20-982. In this case the value of whiskey in bond was determined by use of a publication which purported to determine the actual value of whiskey in bond based on the experience of the trade, including as factors the cost price plus county, State and Federal taxes, storage charges, interest and appreciation in value through ageing of the liquor.

[7] A. R. M. 33, Treasury Bulletin 9-20-765.

[8] See T. D. 2609.

lower, provided that such practice is consistently adhered to in the future. But where market at the close of 1918 or 1919 was below cost and the taxpayer thus had an opportunity to take inventories at a figure lower than cost, he will not now be permitted to change from cost to cost or market, whichever is lower, where it appears that the principal reason for the change is the reduced tax payable. If, however, permission is granted in any of the above cases to change the method of pricing inventory, it is unnecessary to file any amended returns for the past years or make any change in the inventory by reason of the changed method of pricing. Where a change is necessitated because in the past a basis has been used not permitted by the Regulations now nor then, amended returns on one or the other of the two bases now authorized from 1915 to date should be filed. If the adjustments due to the amendment of returns so affect the taxpayer as to occasion an inequality in the tax prior to the year 1915, such inequality may be remedied in the 1915 return by the deduction from or addition to the tax accruing in that year of an amount equal to the net amount overpaid or underpaid in prior years, such amount to be determined by filing with the return for 1915 a composite return for all prior years accompanied by a statement showing the total adjustment for each of the years and the net for the entire period.[9]

The rule applicable to all industries is that inventories should be taken on the basis "(a) cost, or (b) cost or market, whichever is lower." It is recognized that in some industries the actual cost of production can not be ascertained accurately, and it is therefore necessary to approximate a cost value by using selling market prices as a starting point and reducing such selling market prices in each case by an amount sufficient to eliminate the element of profit. This rule is applicable to the inventories of farmers and stockmen, and is widely used in many lines of industry, notably in those types of mining and manufacturing in which a product of more than one grade or

[9] A. R. M. 38, Treasury Bulletin 13-20-804, as recently modified by A. R. M. 85, Treasury Bulletin 43-20-1273.

more than one kind is obtained by a common operation.[10] A taxpayer who for many years has elected to take inventory only every two years, and used an estimated inventory in the return for the intermediate year, making any necessary adjustments in the return for the following year when an actual inventory was taken, may not apportion his total earnings for the two years 1917 and 1918 equally between such years for income tax purposes.[11] After the year 1918 taxpayers will not be permitted to adopt one period for inventorying and closing their books applicable to one part of their business and a different period applicable to another part thereof.[12]

[10] O. 844, Treasury Bulletin 6-19-268.
[11] O. D. 133, Treasury Bulletin 4-19-211.
[12] O. D. 289, Treasury Bulletin 23-19-541.

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INVENTORIES AT COST. Taxpayers who as a matter of settled practiced do not deduct cash discounts from purchases, but who take the merchandise purchased into their inventories at invoice price (less trade or other discounts other than strictly cash discounts), carrying the discounts in a discount account, may not, in valuing their closing inventories, deduct from the invoice price of the merchandise on hand at the close of the taxable year the average amount of cash discount received on such merchandise; neither may the amount of cash discount earned, to be reported as income, be decreased by an amount representing the estimated cash discount received on merchandise on hand at the close of the year.[1]

[1] O. D. 326, Treasury Bulletin 28-19-610.

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INVENTORIES AT MARKET. The rule stated in the first sentence of this paragraph of the 1920 edition has been slightly modified. It may now be stated as follows: Market means the current bid price prevailing at the date of the inventory for the particular merchandise, and is applicable to goods purchased and on hand and to basic materials in goods in process of manufacture and in finished goods on hand, exclusive, however, of goods on hand or in process of manufacture for deliv-

ery upon firm sales contracts at fixed prices entered into before the date of the inventory, which goods must be inventoried at cost.[1]

[1] Reg. 45, Art. 1584, as amended by T. D. 3047, Treasury Bulletin 32-20-1114.

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INVENTORIES BY DEALERS IN SECURITIES. An inventory method of accounts may be availed of by a dealer in securities only as to stocks owned by the dealer at the end of the year. In the process of a "short" sale legal title to stock is transferred from the lender to the borrower and from the borrower to the buyer, and then later from the borrower to the lender. The "short" sale dealer having no stock in his possession to which he has title, consequently has no stock which he can inventory at the end of the year; as soon as title was secured from the lender, it was passed on to the buyer. Since the statute does not authorize the inventorying of liabilities even though the liability is one to return specific property in kind on demand and inasmuch as the word "inventory" in its commonly accepted commercial meaning refers to the inventorying of assets only, a dealer in securities may not inventory stock sold "short" as of the end of the taxable year. Consequently, where a taxpayer has "borrowed" stock in order to make a "short" sale the gain or loss arising from the transaction cannot be accrued upon the books of the taxpayer at the close of his taxable year by treating as an offsetting obligation the market value of the stock sold "short" as of that date; the gain or loss is determined when the amount of stock sold "short" is repurchased for return to the lender and the transaction closed.[1]

[1] S. 1179, Treasury Bulletin 24-19-558.

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INVENTORIES OF LUMBER MANUFACTURERS. Because of the impracticability of determining accurately the costs properly assignable to each species, grade, and dimension of lumber making up the product of the mill, lumber manufacturers may

use as a basis for pricing inventories the average cost to the manufacturer of producing the inventoried products during the taxable year for which the return of net income is made. If the quantity of lumber on hand at the time of inventory is greater than the total quantity of lumber produced during the current taxable year, it is evident that the excess stock has been carried over from the previous year's production, and such excess shall be valued at the average cost of production for the preceding taxable year. A taxpayer who regularly allocates in his books of account such average cost to the different kinds and grades of lumber in proportion to the selling value of such kinds and grades may, subject in each case to the approval of the Commissioner upon audit of the return, make his returns of net income on that basis. The term lumber manufacturer, as thus used, means a person who manufactures lumber from logs, as distinguished from a remanufacturer of lumber.[1]

[1] T. D. 3024, Treasury Bulletin 24-20-995.

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INVENTORIES OF RETAIL DRY GOODS MERCHANTS. Retail 'ry goods dealers who employ the "retail method," which is essentially a "cost" method of valuing inventories, will be permitted to make their returns upon that basis, provided (a) that the use of such method is designated upon the return, (b) that accurate accounts are kept, and (c) that such method be adhered to in subsequent years, unless a change is authorized by the Commissioner. The "retail method" consists in computing the "cost" of goods on hand from the "percentage of purchase mark-up" and the "retail value" of goods on hand. A taxpayer employing the "retail method" of valuing inventories should maintain and preserve in permanent form, for the inspection of internal revenue officers, the accounts and records of each year, together with a schedule of all mark-downs in each department, and such mark-downs should not be included in the computation of the retail value of goods on hand unless the goods so marked down have been actually sold. The following general plan of taking an inventory by

the "retail method" will, it is believed, be found readily adaptable to the requirements of most retail dry goods dealers:

(A) The *percentage of purchase mark-up* is computed as follows: The value of all merchandise, as received, is recorded by departments at two prices, (a) invoice cost plus transportation, and (b) original retail sale price. These cost and retail values are accumulated as recorded during the year. The total retail value minus the total cost value equals the total purchase mark-up, which divided by the total retail value gives the percentage of purchase mark-up.

(B) The *retail value of goods on hand* is computed as follows: A record is kept of (a) the amounts of all sales at retail, (b) any variations from the inventory prices of the preceding year of goods carried over from that year, and (c) any variations from the original sale prices, such as subsequent mark-ups or mark-downs. The retail value of the opening inventories plus the retail value of the purchases (plus or minus the algebraic sum of all subsequent mark-ups, and mark-downs in the case of goods actually sold) minus the retail value of the sales equals the retail value of the book inventory of goods on hand. Physical inventories by departments are taken of goods on hand at retail at the close of the taxable year, and the retail value of the book inventory of goods on hand is adjusted accordingly.

(C) The *cost of goods on hand* is computed by subtracting from 100% the percentage of purchase mark-up, which gives the percentage of cost, and multiplying the retail value of goods on hand by such percentage of cost.[1]

[1] T. D. 3058, Treasury Bulletin 35-20-1162.

CHAPTER 17.

INCOME FROM SALES OR DEALINGS IN PROPERTY—QUASI CAPITAL TRANSACTIONS

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Involuntary Sale. Profits actually realized through the sale of property are not exempt because the sale was involuntary. An involuntary sale constitutes a closed and completed transaction for the purpose of determining gain or loss.[1] Where property owned by an estate was in 1906 listed by a city to be condemned for public purposes but was not destroyed until 1917, during which year a verdict was rendered awarding the estate an amount, with interest at the rate of 6 per cent per annum from 1906, mandamus proceedings being instituted to enforce the settlement of this award, and in 1920 the estate received payment of the face value of the claim, together with interest accrued since 1906, and costs, it was held that as the taxpayer had a claim on March 1, 1913, for the payment of this amount with interest accrued to that date, the measure of taxable income is the difference between the fair market value of the claim for the principal and interest on March 1, 1913, and the sum actually received representing such principal and accrued interest. The cost of mandamus proceedings was a replacement of the amount expended by the estate in the collection of a due debt and should not be included in the gross income of the estate. However, the cost of such mandamus proceedings can not be taken as a deduction in computing net income of the estate for the year in which expended.[2]

[1] A. R. R. 1. Treasury Bulletin 25-19-587.
[2] O. D. 591, Treasury Bulletin 29-20-1071.

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Basis for Determining Gain or Loss from Sale. The use of the fair market price or value of property as of March 1, 1913, as a basis for ascertaining the gain or loss from the sale or

exchange thereof is not optional in the case of property acquired prior to March 1, 1913. In other words, if the fair market price or value of property on March 1, 1913, is lower than cost, it must still be used as a basis, even though it may result in a taxable gain and the difference between cost and selling price represents a loss.[1]

[1] T. B. M. 73, Treasury Bulletin 19-19-493.

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SALE OF PROPERTY ACQUIRED BY GIFT OR BEQUEST. If real estate is devised by a testator to his widow for her life with the direction that upon her death the property shall be sold and the proceeds divided among their children, the basis for ascertaining the gain or loss on a sale of such real estate and the distribution of the proceeds to the children has been held to be the value of the children's rights at the time such rights vested or on March 1, 1913, if they vested prior thereto. Under the doctrine of equitable conversion the interest of the children is regarded as personalty instead of realty, yet the estate acquired by the children was a remainder and vested at the death of the testator.[1] In spite of the provision that the land should be sold the children could have taken the actual land itself after the death of the life tenant instead of the proceeds from its sale.[2] The only difference between the subject matter disposed of by sale in behalf of the children after the death of the life tenant and that acquired by them on the death of the testator is that the former carried with it the actual possession of the property and the latter did not. Notwithstanding that fact, the right to the possession vested in the children at the death of the testator; the enjoyment alone was postponed to the death of the life tenant. Likewise, all the rights which the children acquired with respect to the land vested at the death of the testator and were as perfect then as at the death of the life tenant.[3] The remainder acquired

[1] Cropley v. Cooper, 19 Wall. (U. S.) 167, 22 L. ed. 109; Kelly v. Gonce, 49 Ill. App. 82; DeVaughn v. McLeroy, 82 Ga. 687, 10 S. E. 211.

[2] Jarman on Wills, page 562.

[3] Scofield et al. v. Olcott et al., 120 Ill. 362, 11 N. E. 351, 352; Nichols v. Levy, 5 Wall. (U. S.) 433, 442-3.

by the children on the death of the testator was essentially the same property as the fee simple sold in their behalf after the death of the life tenant. It is also held by the Treasury Department that the exemption in the statute given to property acquired by gift, bequest, devise or descent, refers merely to the value of the property at the time acquired and not to any value subsequently attaching to the property because of the actual or anticipated arrival of the period of enjoyment. Thus, in the above case, while the possession of the property devised did not vest in the children until the death of the widow, the property was acquired by the children *in right* on the death of the testator, and the measure of gain or loss on the sale of the property was held to be the difference between the selling price and the fair market price or value of the remainder interest of the children on March 1, 1913, the testator having died prior to that date. Had the testator died subsequently to March 1, 1913, the measure would have been the difference between the selling price and the fair market price or value on the date of the testator's death.[4] The basis for the determination of gain or loss upon the sale of a vested remainder interest is the value of the interest at the date of the death of the testator, or March 1, 1913, if the testator died prior to that date. This has been held to be true even in the case of an interest subject to being divested in the event of the death of the remaindermen without issue prior to the death of the life tenant, or by the disposition of the property devised during the life tenant's lifetime.[5] Where in the bequest of property the remaindermen have only a contingent interest prior to the death of the life tenant, the basis of determining gain or loss from a sale of the property by the remaindermen is its value as of the date of death of the life tenant.[6] The appraised value of stock as at the time of the creation of a trust estate, by appraisers of a State court, creates a presumption only that the stock is of the appraised value; this presumption may be rebutted by competent evidence to the

[4] Sol. Op. 35, Treasury Bulletin 33-20-1126.

[5] O. D. 694, Treasury Bulletin 43-20-1255.

[6] O. D. 727, Treasury Bulletin 46-20-1301.

effect that the stock was of another value than that appraised.[7] An individual in 1893 purchased a tract of land and deeded it to his wife. Shortly thereafter a part of the land was sold, the purchaser subsequently defaulting under a purchase money mortgage and the husband some time before March 1, 1913, bought in the property at a foreclosure sale placing the title again in his wife's name, the wife from 1913 to 1917, inclusive, including the income from the property in her income tax returns. In 1917 the property was transferred to the husband but the deed was never recorded. For 1918 the income from the property was reported by the husband. In 1919 the property was again sold, the wife giving the deed. The Treasury Department held that the wife was at all times during the period in question the real owner of the property, and any gain or loss upon the sale thereof in 1919 should be included in her return for that year, since the land was deeded to the wife as a *bona fide* gift in 1893, and since the husband who loaned the money to the purchaser and of right held the mortgage upon the property allowed the deed to remain in his wife's name when he bought the property in at the foreclosure sale, and since all the income for the year 1913 to 1917, inclusive, was reported in the wife's returns, indicating the husband's acknowledgment of her right to it. There were other circumstances indicating that the unrecorded deed of 1917 was not considered by the parties as a valid and binding transfer. The deed of transfer in 1919 when the property was sold was executed in the wife's name and the mortgage to secure a portion of the purchase price was taken in her name and later assigned to the husband, the wife continuing to be the record owner until the deed of sale.[8]

[7] A. R. M. 7, Treasury Bulletin 30-19-637.
[8] O. D. 543, Treasury Bulletin 24-20-999.

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Footnote 6.

Add:—O. D. 667, Treasury Bulletin 39-20-1209.

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Footnote 7.

The actual and not the book value of corporate stock governs for income tax purposes. (State v. Lee (Wis.), 178 N. W. 471.)

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SALE OF HOMESTEAD. The basis for determining gain or loss from the sale of a homestead acquired from the Government will be the fair market value of the homestead at the date of its acquisition or the value at March 1, 1913, if acquired prior to that date. The date of acquisition of a homestead acquired by public grant is the date of entry upon the land. The taxpayer will not be entitled to add to the value of the homestead the amount expended for relinquishment in order to clear the Land Office records, nor any fees paid to the Government, but the cost of improvements may be added to the value as of the date of acquisition.[1] The above rule is limited to the original entryman, and has no application to the case of those acquiring Government lands in any other way than under the homestead laws.[2]

[1] O. D. 386, Treasury Bulletin 5-20-712; O. 880, Treasury Bulletin 17-19-470.

[2] O. D. 601, Treasury Bulletin 30-20-1086.

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SALE OF PERSONAL RESIDENCE. Inasmuch as no deduction for depreciation of the personal residence of a taxpayer is allowable in his income tax returns, a taxpayer in determining the gain or loss arising from the sale of his personal residence, continuously occupied by him as such, is not required to reduce the cost of the property or its fair market value as at March 1, 1913, by the depreciation sustained.[1]

[1] O. D. 600, Treasury Bulletin 30-20-1085; see A. R. R. 249, Treasury Bulletin 34-20-1168.

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SALE OF BONDS PURCHASED AT A PREMIUM. When municipal bonds are purchased at a premium and held to the date of maturity, the basis for determining the gain or loss on such

bonds is their purchase price, including the premium, or their fair market value as of March 1, 1913, if acquired prior thereto.[1]

[1] O. D. 726, Treasury Bulletin 46-20-1300.

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Fair Market Price or Value as of March 1, 1913. In general the value as of March 1, 1913, of any kind of property may be established by a consideration of *bona fide* transactions in like property occurring on or about that date, together with all other facts pertaining to such value.[1]

[1] O. D. 7, Treasury Bulletin 1-19-12. See Forms A, N, O and T, in which the value of mines, oil and gas wells and timber lands is to be established by reference among other things, to sales of similar property.

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MARKET VALUE OF SECURITIES ON MARCH 1, 1913. The value of shares of stock on March 1, 1913, should be determined on the basis of market quotations as of that date and not upon the basis of book values.[1] It has been held that in valuing securities as of March 1, 1913, the item of good-will indicated by a sale of all the stock of the corporation in 1916, should be valued as of March 1, 1913, by the application of the capitalization percentage based on earnings attributable to good-will. In this case the Treasury Department rejected a contention that the amount received for good-will in 1916 should be treated as having ratably accrued over the entire period of existence of the corporation from its organization to the date of sale, admitting that such method might be acceptable with respect to good-will as defined by the courts, but denying its applicability to good-will as defined by the Committee on Appeals and Review. That Committee's definition states that the term should be given "not merely the narrow and technical meaning which has been attached to it in numerous court decisions, but to include as well the intangible

[1] A. R. R. 33, Treasury Bulletin 9-20-764. For the distinction between the value of the capital assets of a company and the valuation of shares owned by shareholders, see People v. Coleman, 126 N. Y. 433, 27 N. E. 818, 12 L. R. A. 762.

value which always attaches to a more than usually profitable enterprise by reason of its proven earning capacity."[2]

[2] A. R. R. 252, Treasury Bulletin 34-20-1143.

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Exchanges of Property. "Market value" is the price at which a seller willing to sell at a fair price and a buyer willing to buy at a fair price, both having reasonable knowledge of the facts will trade. The term "market value" implies the existence of a public of possible buyers at a fair price, and recognizes that property has no "fair market value" when market conditions are such that there would be no trading in the property in question at a fair price.[1] Property received in exchange for other property has no "fair market value" for the purpose of determining gain or loss resulting from such exchange when, owing to the condition of the market, there can be no reasonable expectation that the owner of the property, though wishing to sell and any person wishing to buy will agree upon a price at which to trade unless one or the other is under some peculiar compulsion. It does not follow that property has no "fair market value" merely because there is no price therefor established by public sales or sales in the way of ordinary business. The property received in exchange may be real estate, personal property, or a chose in action. Where the owner of a bond exercises the right, provided for in the bond, of converting the bond into stock in the obligor corporation, such transaction does not result in a realization of profit or loss, the transaction not being closed for purposes of income taxation until such stock is sold.[2] In a case in which holdings of stock in a corporation, including shares held prior to March 1, 1913, shares received as dividends after March 1, 1913, and shares acquired by purchase after March 1, 1913, were in 1918 exchanged for shares of stock in several other corporations, but owing to requirements of the Capital Issues Committee a portion of the stock to be received was held in

[1] T. B. R. 57, Treasury Bulletin 19-19-494.

[2] Reg. 45, Art. 1563, as amended by T. D. 2971, Treasury Bulletin 7-20-737. See chapter 17, footnote 30, for a criticism of this definition.

trust during the period of the war, certificates of ownership being issued and final delivery of the stock being made in 1919, the Treasury Department held that the exchange constituted a closed transaction which reflected a gain or loss in the difference between the aggregate value of the shares exchanged and the total market value of the securities received, and that the date of the exchange and not the date of complete delivery determined the taxable period in which such gain or loss should be reported.[3]

[3] O. D. 480, Treasury Bulletin 18-20-892. In determining the aggregate value of the stock exchanged, the Treasury Department held that the value of the stock received as dividends must be determined in the light of the decision in Eisner v. Macomber, recently decided by the U. S. Supreme Court. The value of the original shares of stock as of March 1, 1913, was therefore used for the purpose of determining the gain or loss derived from the disposition of the original shares and the shares received as dividends.

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Footnote 17.

The actual and not the book value of corporate stock governs for income tax purposes. (State v. Lee (Wis.), 178 N. W. 471.)

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Determination of Gain or Loss from Exchange of Property. The exchange of old bonds of a corporation for bonds of a new issue having an extended maturity date and bearing a higher rate of interest is held to be an exchange of property which may result in gain or loss.[1]

[1] O. D. 308, Treasury Bulletin 25-19-580.

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Exchange for Different Kinds of Property. No taxable income accrues on an exchange of bonds purchased prior to March 1, 1913, for 57 per cent. of the face value of the old bonds in new bonds of the same company and 43 per cent. in cash. The cash should be regarded as a return of part of the March 1, 1913, value of the old bonds, and the cost of the new bonds for the purpose of computing gain or loss in case of sale or other disposition of such bonds will be deemed to be

the difference between the cash received at the time of exchange and the value of the old bonds on March 1, 1913.[1] Where a corporation reduced its capital stock by one-half and a stockholder therein surrendered his certificate for 10 shares acquired prior to March 1, 1913, and received in exchange a new certificate for 5 shares and an amount of cash, it has been held that the amount by which the cash exceeded the value as of March 1, 1913, of the five shares surrendered represented taxable income to the stockholder for the year in which the exchange took place. The five new shares are held to have taken the place of the five old shares for which no payment in cash was received.[2]

[1] O. D. 98, Treasury Bulletin 2-19-143.
[2] O. D. 693, Treasury Bulletin 43-20-1254.

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Reorganization, Merger, Consolidation and Dissolution of Corporations. A merger of two or more corporations has been defined by the Treasury Department as taking place when one of such corporations retains its corporate existence and absorbs the other or others, which thereby lose their corporate existence; a consolidation has been defined as taking place when a new corporation is created to take the place of the constituent corporations which are themselves dissolved in the process.[1] For purposes of the stamp tax the term "reorganization" has been held to mean a business arrangement whereby the stock and bonds of a corporation are readjusted as to amount, income or priority, or the issue of one kind of stock is substituted for the issue of another kind, or the property is sold to a new corporation for new stock and bonds, or is sold by foreclosure of a mortgage upon it to a purchaser who buys for himself and his associates, and includes the various proceedings and transactions by which succession of corporations is brought about, and also the proceedings by which existing corporations are continued under a different organization without the creation of a new corporation.[2]

[1] Sol. Op. 4, Treasury Bulletin 22-20-981.
[2] Reg. 40, Rev., Art. 33. See Cook on Corporations, 7th edition, paragraph 883.

The provisions referred to in the 1920 edition upon the subject of the reorganization, merger, or consolidation of corporations and the computation of gain and loss thereon are not applicable to transactions consummated prior to January 1, 1918. The general provision, however, that where property is exchanged for other property, the property received in exchange is for the purpose of determining gain or loss to be treated as the equivalent of cash to the extent of its fair market value, if any, put into the Revenue Act of 1918 a long established precedent which had been followed by the Treasury Department since the adoption of the first income tax statute approved October 3, 1913.[3] It has been held that the market value of stock received upon a reorganization, merger, or consolidation may be determined in the light of sales thereof made soon after its receipt by the taxpayer.[4]

[3] A. R. R. 156, Treasury Bulletin 26-20-1024.

[4] A. R. R. 156, Treasury Bulletin 26-20-1024. This ruling seems of doubtful legality. The market value of the stock received should theoretically, at least, be taken on the precise date when it is received. Certainly, the value should not be taken as of a later date if new factors have intervened between the date of receipt and the date of the dealings therein which would affect such value.

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EXCHANGE OF STOCK FOR OTHER STOCK OF NO GREATER PAR VALUE. The phrase "aggregate par value" means the aggregate par value of stock of each individual stockholder, exchanged for new stock and the aggregate par value of such stock received by each individual stockholder.[1] The word "or" as used in the phrase "stock *or* securities" is held to be synonymous with the word "and" and a person may, in connection with the reorganization, merger or consolidation of a corporation, turn in either stock or securities, or both, and accept either new stock or securities, or both, of no greater par or face value, without being liable for tax upon any gain from such exchange.[2]

A number of cases have arisen in connection with the reor-

[1] O. D. 204, Treasury Bulletin 10-19-353.

[2] O. D. 335, Treasury Bulletin 29-19-623.

ganization, merger and consolidation of corporations in which the stockholders of the old corporation or corporations have been held free from tax on the general ground that the aggregate par or face value of the stock or securities received was less than the aggregate par or face value of those exchanged. Each of these decisions is based upon its peculiar circumstances and should be used with caution in determining any other case. In view of the general importance of the subject the more important of these decisions are briefly reviewed below:

1. The only requirement of the statute is that the new securities received upon the reorganization, merger or consolidation of a corporation or corporations shall have no greater face value than the old. The *actual* value of the respective securities is immaterial. The nature of the respective securities is also immaterial; either the old or new securities may be bonds or stock, or both.[3]

2. Where the stockholders of one of several banks which were consolidated received in exchange for their shares stock of the consolidated bank of no greater aggregate par or face value than their shares in the old bank, bonds purchased by the old bank subsequent to March 1, 1913, at 80 being taken over by the consolidated bank at 70 and later sold by the consolidated bank at 80, the Treasury Department has held that there was no realization of gain or loss at the time of consolidation by either the old bank or its stockholders, and also that the consolidated bank did not receive any profit on the sale of the bonds since it should have placed them on its books at the same figure at which they were carried by the old bank.[4]

3. Mere multiplication of the number of shares of a corporation (resulting from the exchange of four new shares, each having a par value of $25 for each old share of $100 par value) when not accompanied by conversion of surplus into capital stock or revaluation of assets, does not give rise to taxable gain or income to stockholders making the exchange. Where a corporation amends its charter so that instead of

[3] T. B. R. 25, Treasury Bulletin 6-19-267.

[4] O. D. 418. Treasury Bulletin 13-20-803.

having 10,000 shares of no-par value, the same stockholders will hold 100,000 shares without par value, neither the original charter nor the amendment having any stated capital in dollars, this multiplication of shares being not accompanied by conversion of assets into capital stock or any revaluation of assets, such a transaction does not give rise to taxable gain or income to stockholders making the exchange.[5]

4. Where a corporation is insolvent and the bondholders bid in the property at foreclosure sale and for the purpose of reorganization convey it to a new corporation, receiving in exchange for their bonds stock of the new corporation of the same par value, the Treasury Department has held that a bondholder may deduct as a loss in computing his net income under the 1913 Law the amount by which the cost of the bonds, or their fair market value as of March 1, 1913, if acquired prior thereto, exceeds the fair market value at the time of the exchange of the stock received by him.[6]

5. In a case in which two existing corporations were consolidated under the Act of General Assembly of the State of Ohio, approved May 29, 1919, by the exchange of no-par value shares of the new corporation for the entire assets and obligations of each of the existing corporations, which in turn were liquidated, it has been held that the no-par value stock of the consolidated corporation will be deemed to have a par value represented by the aliquot part of the total book value of the properties of the corporations which are consolidated

[5] T. B. R. 39, Treasury Bulletin 12-19-396.

[6] S. 1294, Treasury Bulletin 4-20-698. In this case neither of the old insolvent companies had paid interest on their bonds for some years prior to the foreclosure and the bonds seemed to have depreciated in value by March 1, 1913, practically to the extent of the value of the stock received by the bond-holders in the new corporation. The Treasury Department consequently held that the taxpayer sustained no deductible loss in 1914 when the reorganization was effected. It will be noted that this case was decided under the 1913 Law which contained no provision that where upon the reorganization, merger or consolidation of a corporation a person receives in place of stock or securities owned by him new stock or securities of no greater aggregate par or face value, no gain or loss is deemed to occur from the exchange. (Revenue Act of 1918. Sec. 202 (b).)

and exchanged for the no-par value shares. This decision was based upon the Ohio statute limiting the declaration of dividends to surplus profits arising from the business of a new corporation. Under this provision the net value of the assets of the corporations which were consolidated might not be less than the amount of capital stated in the articles of incorporation as that with which the new corporation was to carry on business. It was not required to be in excess of that amount. If in fact the net value of the assets of the corporations which were consolidated exceeded the amount of capital specified in the articles of incorporation, the excess was deemed paid-in surplus out of which dividends might be paid.[7]

[7] Sol. Op. 72, Treasury Bulletin 45-20-1286.

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Determination of Gain or Loss from Subsequent Sale. The new stock and securities received as described in the preceding paragraph of the 1920 edition take the place of the old stock and securities. For the purpose, therefore, of ascertaining the gain derived or loss sustained from the subsequent sale of any stock of A or of the consolidated corporation, so received, the original cost to the taxpayer or the fair market value as of March 1, 1913, of the stock of B or A in respect of which the new stock was issued, less untaxed distribution made to the taxpayer by A out of the former capital or surplus of B, or by the consolidated corporation out of the former capital or surplus of A or B, is the basis for determining the amount of such gain or loss. When securities of a single class are exchanged for new securities of the same total par value but of different classes, for purposes of determining profit or loss on subsequent sale of any of the new securities, the proportion of original cost (or value as of March 1, 1913) to be allocated to each class of new securities is that proportion which the market value of the particular class bears to the market value of all securities received on the date of the exchange. For example, if 100 shares of common stock par value $100 are exchanged for 50 shares of preferred and 50 shares of common each of $100 par value, and the cost of the

old stock was $250 per share, or $25,000, but the market value of the preferred on the date of exchange was $110 per share, or $5,500 for the 50 shares, and the market value of the common was $440 per share, or $22,000 for the 50 shares of common, one-fifth of the original cost, or $5,000, would be regarded as the cost of the preferred and four-fifths, or $20,000, as the cost of the common. Similarly, the cost after reorganization, merger, or consolidation of the assets of A or of the consolidated corporation is the sum of the cost (or the fair market value as of March 1, 1913) of the assets of A and B for the purpose of ascertaining the gain or loss upon a subsequent sale. The new invested capital of A or of the consolidated corporation is to be determined as if A and B were rendering a consolidated return as affiliated corporations.[1]

[1] Reg. 45, Art. 1568, as amended by T. D. 2963, Treasury Bulletin 4-20-699.

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EXCHANGE OF STOCK FOR OTHER STOCK OF GREATER PAR VALUE. In a number of cases involving the reorganization merger or consolidation of corporations in which the aggregate par or face value of the stock or securities received exceeded the aggregate par or face value of the stock or securities exchanged, the stockholders of the old corporation or corporations have been held liable to income tax. Each of these decisions is based upon its peculiar circumstances and should be used with caution in determining any other case. In view of the general importance of the subject the more important of these decisions are briefly reviewed below:

1. A company whose operations had proved very profitable was reorganized, two new corporations being formed, one to take over its production business and the other its pipe-line business. By the reorganization the stockholders of the old company came into the possession of stock of a holding company and the two reorganized companies and bonds of the two reorganized companies of a greater aggregate par or face value than their old stock. The beneficial interests in the enterprise

remained the same. This transaction was held to produce taxable income to the stockholders of the old company.[1]

2. Where in connection with a reorganization of a company a stockholder has the right to make an exchange in one year, but does not *actually make* the exchange until the following year, the profit accruing is to be deemed income in the year in which the exchange is actually made.[2]

3. In a case decided under the Massachusetts Statute the complainant was the owner of 2300 shares of common and preferred stock of an ascertained value on January 1, 1916 (the date of incidence of the Massachusetts tax). In the following July she used this stock as consideration with which to subscribe for and acquire 4,125 shares of common stock in a new and different corporation formed to take over the assets of the old, the new stock having a greater total par value than the old. The new corporation became the owner of substantially all of the stock of the old company and caused to be transferred to itself all the assets of the old company and carried on the business of the latter through the same officers without interruption and without outward indication of change. The Court held that the complainant was subject to tax on the difference between the value on January 1, 1916, of the stock of the old company and the market value of the stock of the new company at the time of transfer.[3]

[1] A. R. M. 67, Treasury Bulletin 28-20-1049.

[2] A. R. K. 289, Treasury Bulletin 44-20-1274.

[3] Osgoode v. Tax Commissioner (Mass.), 126 N. E. 371. The court said: "Although the property owned by the new corporation was identical with that owned by the old corporation, it nevertheless plainly was a different legal entity * * * The stock obtained by the complainant through exchange was different in kind and not merely in degree from that which she owned before. It was not the same corporation and the stock itself was different in nature, a change of investment had been made both in name and essence." (See also Stone v. Tax Commissioner (Mass.), 126 N. E. 373.)

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Exchange of Property for Stock. In several cases in which property has been turned over to a corporation formed for the purpose, the Treasury Department has held the owner of the

property taxable to the extent of the difference between the market value of the stock received and the value of the property on March 1, 1913, or its cost, if acquired subsequently to that date even though the beneficial interest in the property was not substantially changed by the transaction.[1] The facts in these cases and the decisions of the Treasury Department are briefly reviewed below:[2]

1. Several individuals secured leases on certain land. Subsequently and prior to March 1, 1913, they entered into a contract with another individual whereby 3000 acres of the land were assigned to the latter individual under the so-called checkerboard plan and under which the assignee obligated himself to develop the field. If oil or gas was not found in the field by a well drilled to the depth of 1200 feet, the assignee had the option of abandoning the contract. The assignee went upon the property and drilled a well after March 1, 1913, which struck oil. Subsequently in August, 1913, the leases in question were transferred to a corporation in exchange for the stock thereof, the major portion of which was sold by the stockholders in 1916. Under these circumstances the Treasury Department held the stockholders of the corporation taxable in the year 1913 on the difference between the value of the stock received by them in August, 1913, and the value of their stock as of March 1, 1913. In determining such value as of March 1, 1913, it was recommended that the original cost of the leases transferred to the corporation plus the approximate cost of the wells sufficient to determine whether or not oil was present should be accepted; that upon the sale of the stock in

[1] The Treasury Department bases its attitude in this respect in large part upon the refusal of Congress in drafting the Revenue Act of 1918 to permit to go into the law as enacted a provision proposed in a Senate amendment to the effect that when a person or persons owning property received in exchange for such property stock in a corporation formed to take over such property, no gain or loss was to be deemed to accrue from the exchange. (See A. R. R. 173, Treasury Bulletin 28-20-1050; A. R. M. 67, Treasury Bulletin 28-20-1049.)

[2] See in addition to cases below, A. R. M. 94, Treasury Bulletin 47-20-1310.

1916 the profit should be computed on the basis of the value of the stock in August, 1913.[3]

2. A taxpayer individually built and owned a railroad constructed for the sole purpose of carrying the product of his mills to stations on other roads for distribution. In 1914 the State Railroad Commission required the incorporation of this road. The Commission permitted the issuance of stock by the corporation in an amount somewhat exceeding the net assets of the road upon the basis of an appraisal on March 1, 1913, and the cost of additions between that date and the date of incorporation, making due allowance for bond issue. The taxpayer contended that the property was worth at the time of incorporation the amount for which it was incorporated and that (a) a profit was made in 1914 at the time of incorporation, and (b) a loss was suffered upon the sale of the stock in 1917.

The Treasury Department held that while in the ordinary case of an exchange of property for stock, the latter will be deemed to be worth its par value in the absence of evidence to the contrary, the above appraisal indicated a value of less than par. Consequently the loss claimed upon the sale in 1917 was converted into a profit by the use of the appraised value of the railroad property in lieu of the par value of the capital stock issued by the company. The Treasury Department agreed with the taxpayer's general contention indicated under (a) above, but the use of such appraised value precluded any profit upon the organization of the corporation in 1914.

3. In a case in which an inventor formed a company and issued stock based upon his invention, the market value of which when issued was unknown, but for which stock the inventor subsequently proceeded to establish a market, receiving as compensation shares of the company's stock which he sold afterwards in the open market at more than par value, the Treasury Department has held that the amount received for the stock when sold in excess of its par value might reasonably be attributed to the inventor's efforts at publicity and

[3] A. R. R. 173, Treasury Bulletin 28-20-1050.

the market value of the stock when received considered equal to its par value.[4]

In a case arising under the 1909 Law the defendant purchased in 1909 certain properties, the legal title to which was taken in the name of its president, as trustee. Later in the same year, pursuant to a plan for increasing the capital stock of the defendant, these properties were conveyed by the trustee to a corporation which had been formed for the express purpose of thus acquiring and using them in carrying out the recapitalization scheme. The consideration of the conveyance was the issuance by the latter company to the trustee of practically its entire capital stock. The stock thus issued to the trustee was immediately transferred by him to the defendant, which in turn distributed it among its stockholders, share for share. Thereupon, in furtherance of the recapitalization plan, a merger was effected between the defendant and the new company. For purposes of the merger, the value of properties so conveyed to the new company (which constituted all of its assets) was fixed at the same figure as that at which the trustee had conveyed them to that company; also, before the stock was distributed among the defendant's stockholders, it was formally valued by its directors at par. The par value of such stock greatly exceeded the price at which the property had originally been purchased by the defendant. The defendant did not include as income in its tax return the apparent profit resulting from the difference between the price which it had originally paid for the properties and the price at which it had ostensibly sold them to the new company. The government took the position that the illegal profit—both the purchase and sale having taken place within the year 1909—was taxable income of that year under the 1909 Law, but the court held to the contrary.[5]

[4] O. 962, Treasury Bulletin 1-20-656.

[5] Alpha Portland Cement Co. v. U. S., 261 Fed. 339. The court said: " * * * it is apparent that while, as a matter of form and of bookkeeping, the defendant did realize a very considerable profit during the tax year in question on the purchase and transfer of these properties, yet in reality it made no profit whatever. The ultimate and real result of the various transactions was that the defendant purchased some

properties at one figure, and in working out a plan of recapitalization valued them at a higher figure. The intermediary corporation, to which the legal title of the properties was conveyed by the trustee, was brought into being by the defendant for the express purpose of working out the recapitalization plan, and ceased to exist as a separate entity after that plan had been carried out. The defendant was no richer after the alleged sale than it was before, nothwithstanding the book entries, resolutions of directors, transfers of title, etc. Viewed in this light, we think that it needs no argument to demonstrate that the case falls within the principle of the decisions of the Supreme Court in Southern Pacific v. Lowe, 247 U. S. 330, 38 Sup. Ct. 540, 62 L. ed. 1142, and Gulf Oil Corp. v. Lewellyn, 248 U. S. 71, 39 Sup. Ct. 35, 63 L. ed. 133. Indeed, it cannot be distinguished on principle from the decision of this court in Baldwin Locomotive Works v. McCoach, 221 Fed. 59, 136 C. C. A. 660."

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Evasion of Tax on Sale of Corporate Assets by Conveyance to Trustees. A change of form from that of a corporation or association to that of a trust or partnership accompanied by a transfer of capital assets to trustees for the benefit of shareholders followed by a sale of such assets at a price in excess of the cost thereof to the corporation or association, and the distribution of proceeds to the beneficiaries (shareholders), such change being made for the main purpose of avoiding the tax which would accrue to the corporation had the sale been made by it, will be disregarded by the Treasury Department as a mere sham to avoid assessment of tax against the corporation or association upon the profit derived from such sale, and the corporation or association will be required to return as income any profit derived as though the sale had been made by it directly.[1]

[1] S. 1385, Treasury Bulletin 19-20-928. For cases on the general principle that where the effect of a transaction is to evade the payment of a tax, the courts will look beyond the surface facts and sham devices and inquire into the real nature of the transaction, see Sisler v. Foster, 72 Ohio 437, 74 N. E. 649; People v. Albany Ins. Co., 92 N. Y. 458; People v. Sawyer, 27 N. Y. Supp. 202; Pollard v. First Nat. Bank, 47 Kans. 406, 28 Pac. 202; Ransom v. Burlington, 111 Iowa 77, 82 N. W. 427; Stefel v. Brown, 24 Mo. App. 102; Holly Springs, etc, v. Supervisors, 52 Miss. 281; Jones v. Seward Co., 10 Nebr. 154, 4 N. W. 946; Mitchell v. Commissioners, 9 Kans. 344, 91 U. S. 206; Albany City National Bank v. Maher, 6 Fed. 417, 19 Blatch. 175; Shotwell v. Moore, 45 Ohio 632, 16 N. E. 470, 129 U. S. 590; Durham v. State, 6 Ind. App.

23, 32 N. E. 104; Peppleton v. Yamhill, 8 Ore. 337. See also Southern Pacific Co. v. Lowe, 247 U. S. 330, 38 Sup. Ct. 540; Gulf Oil Corporation v. Lewellyn, 248 U. S. 71, 39 Sup. Ct. 35. The distinction between a legal avoidance and an improper evasion must be kept in mind. (Bullen v. Wisconsin, 240 U. S. 625, 36 Sup. Ct. 473; U. S. v. Isham, 17 Wall. (U. S.) 476.)

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Sale of Insurance Policy. The basis for ascertaining the taxable income resulting from the disposition of a life insurance policy acquired prior to March 1, 1913, where the insured transfers the policy to some one other than the insurance company which wrote the policy, is the cash surrender value of the policy as at March 1, 1913. However, if the insured surrenders his policy and all his rights thereunder to the insurance company which wrote the policy, the aggregate amount of the premiums paid during the period the policy was held, or the cash surrender value of the policy as at March 1, 1913, whichever is greater in amount, is to be taken as the basis in computing the taxable income derived by the insured.[1] Where a corporation which carried insurance policies on the lives of its officers under which it was named as the beneficiary sells the policies for a sum less than the total premiums paid (and not deducted from gross income), no part of the amount received for the policies is taxable.[2] An insurance policy is property.[3] In determining the question of the taxable gain arising upon exchanges of insurance policies, such exchanges are to be divided into classes as follows:

(1) Cases in which the second policy at the time of issuance has no readily determinable cash value, and

(2) Cases in which the second policy at the time of issuance has a readily determinable cash value, and

(a) The value of the surrendered policy as of March 1, 1913, is greater than the gross premiums charged prior to that date, less amounts returned, deducted or abated therefrom, or

(b) The value of the surrendered policy as of March 1, 1913, is not greater than the gross premiums charged prior to

[1] O. D. 379, Treasury Bulletin 4-20-701.

[2] O. D. 724, Treasury Bulletin 45-20-1297.

[3] Ionia Co. Savings Bank v. McLean, 84 Mich. 629, 48 N. W. 159.

that date, less amounts return, deducted, or abated therefrom.

In cases falling in class 1 no taxable gain arises from the exchange.

In cases falling in class 2(a) the taxable gain, if any, arising from the exchange is the amount whereby (1) the sum of the value of the policy surrendered as of March 1, 1913, plus the gross premiums subsequently charged, less amounts returned, deducted, or abated therefrom, is exceeded by (2) the cash, if any, received upon surrender of the first policy, plus the cash value of the second policy.

In cases falling in class 2(b) the taxable gain, if any, arising from the exchange is the amount whereby (1) the gross premiums charged at any time, either before or on or after March 1, 1913, less sums returned, deducted, or abated therefrom, are exceeded by (2) the cash, if any, received upon surrender of the first policy plus the cash value of the second policy.[4]

[4] Sol. Op. 55, Treasury Bulletin 36-20-1181.

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Sale of Mines, Oil and Gas Wells. In computing the gain or loss from the sale of mines, oil and gas wells discovered on or after March 1, 1913, a taxpayer is not entitled to set up the value as of the date of discovery, or within 30 days thereafter, as the basis of the computation. The provision of the Revenue Act of 1918 fixing the basis for determining gain or loss from the sale of property as the fair market value of such property as of March 1, 1913, or its cost, as the case may be, contains no exception.[1] The provision of the statute relating to value at the date of discovery, or within 30 days thereafter, relates to the *depletion allowance* and not to a sale of mines, oil and gas wells.[2] The fact that this construction of the statute involves a discrimination in favor of a discoverer who *operates* and against a discoverer who *sells*, does not affect this conclusion, since the statute is free from ambiguity. Moreover, a construction of the statute permitting a taxpayer to set up

[1] See Revenue Act of 1918, Sec. 202 (a).

[2] Revenue Act of 1918, Sections 214 (a) 10 and 234 (a) 9.

a value as of the date of discovery, or within 30 days thereafter, for the purpose of determining gain or loss upon a sale would negative the provisions of the statute limiting the surtax and the war-profits and excess-profits tax upon a sale of mines, oil and gas wells.[3]

[3] Sol. Op. 26, Treasury Bulletin 29-20-1068.

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Footnote 33.

For a definition of the term "good will" as construed by the Treasury Department, see A. R. R. 252, Treasury Bulletin 34-20-1143.

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Sale of Good Will. Where a corporation sells its assets, including good will, to a competing corporation, one condition to the sale being an agreement by the president of the vendor corporation not to engage in similar business, for which he is paid a money consideration, the amount so received by the president does not represent a conversion of capital but is income for the year of its receipt.[1]

[1] O. D. 668, Treasury Bulletin 39-20-1210; L. O. 1045, Treasury Bulletin 41-20-1231; A. R. R. 250, Treasury Bulletin 34-20-1157.

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VALUATION OF INTANGIBLE PROPERTY. No specific rule can be laid down for determining the value of intangible property which would be applicable in all cases and under all circumstances. Where there is no established market to serve as a guide, the question of value even of tangible assets, is one largely of judgment and opinion, and the same thing is even more true of intangible assets such as good will, trade-marks, trade brands, etc. The Committee on Appeals and Review, however, has suggested several methods of valuing good will which, while not to be regarded as controlling, may serve as checks on the taxpayer's valuation of such intangibles. It has been the practice of distillers and wholesale liquor dealers in numerous instances to put out under well-known and popular brands only so much goods as could be marketed without affecting the established market price therefor and to sell other

goods of the same identical manufacture, age and character under other brands or under no brand at all at figures very much below those which the well-known brands commanded. In such cases the difference between the price at which whisky was sold under a given brand name and also under another brand name, or under no brand, multiplied by the number of units sold during a given year gives an accurate determination of the amount of profit attributable to that brand during that year, and where this practice is continued for a long enough period to show that this amount was fairly constant and regular and might be expected to yield annually that average profit, by capitalizing this earning at the rate, say, of 20 per cent., the value of the brand is fairly well established.

Another method is to compare the volume of business done under the trade-mark or brand under consideration and profits made, or by the business whose good will is under consideration, with the similar volume of business and profit made in other cases where good will or trade-marks have been actually sold for cash, recognizing as the value of the first the same proportion of the selling price of the second, as the profits of the first attributable to brands or good will, is of the similar profits of the second.

The third method and possibly the one which will most frequently have to be applied as a check in the absence of data necessary for the application of the preceding ones, is to allow out of average earnings over a period of years prior to March 1, 1913, preferably not less than five years, a return of 10% upon the average tangible assets for the period.[1] The surplus earnings will then be the average amount available for return upon the value of the intangible assets, and it is the opinion of the committee that this return should be capitalized upon the basis of not more than five years' purchase—that is to say, five times the amount available as return from intangibles should be the value of the intangibles.

In view of the hazards of the business, the changes in popu-

[1] The 10 per cent should be applied only to the tangible assets entering into net worth including accounts and bills receivable in excess of accounts and bills payable (A. R. M. 68, Treasury Bulletin 28-20-1048).

lar tastes and the difficulties in preventing imitation or counterfeiting of popular brands affecting the sales of the genuine goods, the committee is of the opinion that the figure given of 20% return on intangibles is not unreasonable, and it recommends that no higher figure than that be attached in any case to intangibles without a very clear and adequate showing that the value of the intangibles was in fact greater than would be reached by applying this formula.

The foregoing is intended to apply particularly to businesses put out of existence by the prohibition law, but will be equally applicable so far as the third formula is concerned, to other businesses of a more or less hazardous nature. In the case, however, of valuation of good will of a business which consists of the manufacture or sale of standard articles of every-day necessity not subject to violent fluctuations and where the hazard is not so great, the committee is of the opinion that the figure for determination of the return on tangible assets might be reduced from 10 to 8 or 9% and that the percentage for capitalization of the return upon intangibles might be reduced from 20 to 15%.

In any or all of the cases the effort should be to determine what net earnings a purchaser of a business on March 1, 1913, might reasonably have expected to receive from it, and therefore a representative period should be used for averaging actual earnings, eliminating any year in which there were extraordinary factors affecting earnings either way. Also, in the case of the sale of good will of a going business the percentage rate of capitalization of earnings applicable to good will shown by the amount actually paid for the business should be used as a check against the determination of good will value as of March 1, 1913, and if the good will is sold upon the basis of capitalization of earnings less than the figures above indicated as the ones ordinarily to be adopted, the same percentage should be used in figuring value as of March 1, 1913.[2]

A contemporary sale of stock will be considered as having greater weight in determining the value of a corporation's

[2] A. R. M. 34, Treasury Bulletin 10-20-777; A. R. R. 252, Treasury Bulletin 34-20-1143.

assets, including good will as of March 1, 1913, than values based on appraisal.[3]

[3] O. 791, Treasury Bulletin 1-19-22.

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Sale of Personal Property on Installment Plan. Dealers in personal property ordinarily sell either for cash, or on the personal credit of the buyer, or on the installment plan. Occasionally a fourth type of sale is met with, in which the buyer makes an initial payment of such a substantial nature (for example, a payment of more than 25%) that the sale, though involving deferred payments, is not one on the installment plan. In sales on personal credit, and in the substantial payment type just mentioned, obligations of purchasers are to be regarded as the equivalent of cash,[1] but a different rule applies to sales on the installment plan. Dealers in personal property who sell on the installment plan usually adopt one of four ways of protecting themselves in case of default: (a) through an agreement that title is to remain in the seller until the buyer has completely performed his part of the transaction; (b) by a form of contract in which title is conveyed to the purchaser immediately, but subject to a lien for the unpaid portion of the purchase price; (c) by a present transfer of title to the purchaser, who at the same time executes a reconveyance in the form of a chattel mortgage to the seller; or (d) by conveyance to a trustee pending performance of the contract and subject to its provisions. The general purpose and effect being the same in all of these plans, it is desirable that a uniformly

[1] The Treasury Department recognizes that in many sales of that type the obligations of purchasers, even though represented by notes or other paper in negotiable form, cannot be discounted or otherwise converted into cash without material loss because of lack of credit on the part of the buyer and the nature of the property covered by such contract. In such cases the profits from such sales may be computed in accordance with the rules prescribed for sales or contracts for sale of personal property on the installment plan, provided the taxpayer chooses to do so as a matter of consistent practice and attaches to his return a statement disclosing that fact and showing conclusively that the obligations of the purchasers are not the equivalent of cash. (O. D. 715, Treasury Bulletin 45-20-1287.)

applicable rule be established. The rule prescribed is that in the sale or contract for sale of personal property on the installment plan, whether or not title remains in the vendor until the property is fully paid for, the income to be returned by the vendor will be that proportion of each installment payment which the gross profit to be realized when the property is paid for bears to the gross contract price. Such income may be ascertained by taking as profit that proportion of the total cash collections received in the taxable year from installment sales, (such collections being allocated to the year against the sales of which they apply) which the annual gross profit to be realized on the total installment sales made during each year bears to the gross contract price of all such sales made during that respective year. In any case where the gross profit to be realized on a sale or contract for sale of personal property has been reported as income for the year in which the transaction occurred, and a change is made to the installment plan of computing net income, no part of any installment payment received subsequently to the change, representing income previously reported on account of such transaction, should be reported as income for the year in which the installment payment is received; the intent and purpose of this provision is that where the entire profit from installment sales has been included in gross income for the year in which the sale was made, no part of the installment payments received subsequently on account of such previous sales shall again be subject to tax for the year or years in which received. Where the taxpayer makes a change to this method of computing net income his balance sheet should be adjusted conformably. If for any reason the vendee defaults in any of his installment payments and the vendor repossesses the property, the entire amount received on installment payments, less the profit already returned, will be income of the vendor for the year in which the property was repossessed, and the property repossessed must be included in the inventory at its original cost to himself, less proper allowance for damage and use, if any. If the vendor chooses as a matter of consistent practice to treat the obligations of pur-

chasers as the equivalent of cash, such a course is permissible.[2] If the vendee defaults in installment payments and the vendor is unable to recover the personal property sold, he should report as loss on the return for that year the difference between the total amount actually received and the cost, plus amounts returned as profits from sales during former years.[3] Income from installment sales to be returned in each taxable year will consist of: (1) Such part of the installments received during the year (excluding those installments received on account of property repossessed during the year) as represents realized profit. Installments received during the year are to be included whether the sales were effected in an earlier or in the current taxable year. The profit on such installments should be computed by taking the same percentage of the installment receipts as the gross profit to be realized on the total install-

[2] Reg. 45, Art. 42, as amended by T. D. 3082. In England it has been held that the phrase, "annuities or other annual profits or gains," as used in 5 & 6 Vict., Chapter 35, § 102, which imposes an income tax on same, does not apply to installments of the purchase price of an estate, although such payments are due yearly and extend over a long period of years, the installments being regarded as parts of a debt or capital, and not profits and gains to which the act applies, and this even though a part of the installments consists of profits. (Foley v. Fletcher [1858] 3 Hurst. & N. 769, 157 Eng. Reprint, 678, 28 L. J. Exch. N. S. 100, 5 Jur. N. S. 342, 7 Week. Rep. 141, 4 Mor. Min. Rep. 130.) In regard to sales, both of real and personal property, where title passes immediately to the vendee, the Treasury Department's early rulings permitted the return of the profits from the sale as income for the year in which the sale was made. If the buyer forfeited his contract and failed to meet any of the payments contracted to be made, the vendor was permitted to deduct from his gross income as a loss such proportion of the defaulted payments as was previously returned as income. The early rulings. where title did not pass absolutely to the vendee, are contained in a letter from the Treasury Department dated March 14, 1917; Income Tax Primer, December 17, 1917, Question 32. On April 25, 1918, in T. D. 2707 the Treasury Department modified Reg. 33 Rev. Arts. 117 and 120 and established the ruling that until personal property sold on the installment plan is fully paid for, the income to be returned by the vendor will be that proportion of each installment payment which the gross profit to be realized when the property is paid for bears to the gross contract price.

[3] Letter from Treasury Department dated July 10, 1919; I. T. S. 1919. ¶ 3486.

ment sales made during the taxable year bears to the gross contract price of all such sales. Any necessary corrections to produce a more accurate result can be made as at the end of the taxable year. (2) The profits, if any, on contracts which during the year have been canceled, the goods being repossessed by the vendor. In such cases the entire profit realized on the canceled contract, less so much thereof as has been returned in previous years, should be returned as profit of the taxable year in which the goods are repossessed. In estimating such profit the value of the repossessed article (taken at its cost to vendor, less proper allowance for damage and use) should be taken into account, as well as all installments received on account of the contract. Where an installment house makes sales which are not on the installment plan, the profit on such completed sales will be determined in the regular manner.[4] The following is an illustration of the computation of income from sales of personal property on the installment plan: In 1917 goods which cost $10,000 are sold on installment plan for $20,000. Collections on account: 1917, $10,000; 1918, $9,800. One contract, originally for $500, is defaulted in 1918 and the goods which cost the vendor $250 are repossessed, being then worth $50. Installments on this defaulted contract had been paid as follows: 1917, $100; in 1918, $200. The profits to be returned in 1918 are:

Under (1) 50% of $9,600 ($9,800—$200)			$4,800
Under (2) total installments received		$300	
Less-Profit returned in 1917	$ 50		
Shrinkage in goods repossessed ($250—$50)	200		
		250	
			50
Total profit returnable in 1918			$4,850

For simplicity, the above illustration omits sales in 1918. If sales in 1918 contain a different percentage of profit than those in 1917, some adjustment may be necessary. Where the adop-

[4] Letter from Treasury Department dated April 26, 1919; I. T. S. 1919, ¶ 3317.

tion of the method outlined above involves a change in the method of computing net income, the taxpayer's balance sheet should be adjusted conformably as of the date when the change is effected. If the vendor chooses as a matter of consistent practice to treat the obligations of purchasers as the equivalent of cash, such a course is permissible.[5]

The following has been adopted where a taxpayer engaged in merchandising upon the installment plan has heretofore made returns upon the basis of treating the profit upon installment sales as realized as at the date of sale and now wishes to change to the basis of reporting the profit as being realized as at the date of collection of the outstanding accounts.

In accordance with the rule above stated the balance sheet as at the beginning of the taxable year, which should be filed as a part of the return, will carry the installment sales contracts unliquidated and remaining in force as at the date that this system of accounting is adopted and made effective by the taxpayer, as accounts receivable, such unliquidated installment sales contracts having been inventoried and determined as at that date. Cash collections on account of such contracts will be credited directly to such accounts receivable and no part of such collections will be included in computing realized profits for the taxable year. As from the beginning of the taxable year, the following accounts should be set up:

(a) *Goods purchased,* which will be charged with the amount of inventory of the goods on hand at the beginning of the taxable year and with the expenditures for goods purchased during the year.

(b) *Goods sold* (cost value), which will be credited with the cost value of all goods sold during the year.

(c) *Installment sales contracts* (year date), which will be charged only with the amount of installment sales contracts made during the year specified. This account for each year will be credited with all cash collected during that year, or in subsequent years, upon installment sales contracts for that

[5] Letter from Treasury Department dated July 10, 1919; I. T. S. 1919, ¶ 3486, T. D. 3082.

year only, and with the unpaid installments of defaulted or canceled contracts for that year.

(d) *Unrealized gross profits on installment sales contracts* (year date), which will be credited only with the amount of unrealized gross profits upon installment sales contracts made during the year specified. This amount will be the total of the installment sales contracts for that year reduced by the cost or inventory value (as carried in account (a) goods purchased), of the actual goods sold and covered by the contracts; the balance remaining being the amount of the unrealized gross profits. The proforma monthly (or annual) journal entry would be:

	Dr.	Cr.
Installment sales contracts (year date)	$----	
To goods sold (cost value)		$----
Unrealized gross profits on installment sales contracts (year date)		$----

(e) *Realized profits on installment sales contracts,* which will be credited from month to month (or at the end of the year), with the profits realized by cash collections upon all installment sales contracts of any year. Such profits should be computed by taking the same percentage of the cash collections made during the taxable year on account of installment sales contracts of either that or prior years, as the total unrealized profits on installment sales contracts for the year against which the collection applies, bear to the total installment sales made during that respective year. Corresponding debits should be made to *unrealized gross profits on installment sales contracts* for the year affected by such collections. If adjustments to any or all of these various accounts become necessary in order that it or they may accurately reflect the facts, such adjustments may be made either monthly or as at the end of the taxable year.

It will be noted that the foregoing plan which will be permitted upon an explicit statement of facts made to the Commissioner by a taxpayer engaged in merchandising upon the installment plan is not a change from an accrual basis to a cash received and paid basis. In the opinion of the Commissioner,

the income of a merchandising concern can not be correctly reflected upon the latter basis, as the use of inventories is absolutely essential. The plan herein outlined is, therefore, merely such a modification or adaptation of the ordinary accrual method of accounting as in the opinion of the Commissioner will enable the accounts of the taxpayer clearly to reflect his net income. Where in the past another method has been used that has failed to reflect the taxpayer's net income an amended return or returns for such year may be made.

In cases where the taxpayer has in the past exercised the option of reporting the profit as realized as at the date of sale and now wishes to change to a basis of reporting the profit as realized as at the date of collection of the outstanding installments, either of which method is allowable, amended returns for years prior to the date that the above outlined system of accounting is adopted and made effective by the taxpayer, will not be required or allowed unless in the opinion of the Commissioner such former method has failed to reflect the net income.[6] The Commissioner will not approve such a change merely because the taxpayer will derive an advantage from decreased tax liability. When a change is approved the taxpayer will be required to adhere to it in his returns for subsequent years and the first return made under the changed method should be accompanied by a letter of explanation. C. O. D. and "will call" sales should be included in the inventory at the close of the year, if the merchandise has not been actually shipped to the customers, unless such merchandise has been included in sales of the taxable year, in which case it should be excluded from inventory.[7] The treatment outlined above for sales of personal property on the installment plan is not limited to dealers alone, or to sellers of chattels as distinguished from sellers of other forms of personal property, such as corporate stock. The retention of a lien upon the property sold as security for the purchaser's agreement to pay, does

[6] O. D. 623, Treasury Bulletin 32-20-1118, modifying T. B. R. 24, Treasury Bulletin 8-19-313.

[7] O. D. 24, Treasury Bulletin 1-19-36.

[8] S. 1353, Treasury Bulletin 13-20-806; O. D. 482, Treasury Bulletin 18-20-894.

not alter this conclusion.[8] A corporation doing business on both a cash and installment basis should report profits on the installment sales on the basis outlined above. The cash sales, each of which represents a completed and closed transaction, should be reported separately that is, the entire profits derived from every cash sale must be reported as income in the return for the year in which the sale was made.[9] If the principal stockholder of a corporation sells stock to employees of a company for consideration of 10 per cent. cash and the balance in installment payments secured by notes covering a period of 10 years, that proportion of each installment payment received during the taxable year which the gross profit to be realized bears to the gross contract price should be reported as income for the year during which installment payments were received.[10] If books have been so kept that the cost of each article sold was not shown, gross profit may be determined by taking the average percentage of gross profit on gross sales. If several different lines of merchandise are handled on which the average percentages of profit differ, the gross profit on total sales of each different class of merchandise should be computed separately.[11]

[9] O. D. 23, Treasury Bulletin 1-19-35.
[10] O. D. 134, Treasury Bulletin 4-19-212.
[11] O. D. 25, Treasury Bulletin 1-19-37.

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Sale of Real Estate in Lots. Profit realized on the sale of lots, the selling price of which includes the cost of certain development work already made or to be made in accordance with the contract of sale, should be based on the cost of the land to the vendor, or its fair market value as of March 1, 1913, if acquired prior to that date, plus the actual and estimated future expenditures for development. If the estimated future expenditures should be subsequently ascertained to be incorrect, amended returns should be filed as the basis for an adjustment of the tax for the years affected. The cost of such development having been taken into consideration in determin-

ing profit, expenditures for this purpose can not be deducted from gross income in subsequent returns.[1]

[1] O. D. 567, Treasury Bulletin 27-20-1036; O. D. 226, Treasury Bulletin 12-19-399.

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Sale of Real Estate Involving Deferred Payments. No realization of gain or loss arises from a mere contract to sell real estate in the future. The sale is held to occur at the time a deed passes or at the time possession and the burdens and benefits of ownership are from a practical standpoint transferred to the buyer, whichever occurs first. Payments made prior to the sale are to be applied in reduction of cost so far as they do not exceed cost; being treated as income to the extent, if any, to which cost is exceeded.[1]

In the case of real estate sales involving deferred payments, even though substantial first payment is made, if the notes given by buyers of real estate can not be discounted nor sold on account of lack of credit of the buyers, such notes need not be regarded as the equivalent of cash, and the vendors may report as their income from the proposed transaction for each year only the proportion of each payment actually received in that year which the gross profit to be realized when the property is paid for bears to the gross contract price.[2]

Where pursuant to a contract to sell real estate executed in one year at which time a small cash consideration was paid, delivery of the deed and transfer of possession taking place in the next year, in which latter year a substantial payment was made and notes secured by mortgage for the unpaid balance were given, it has been held that the vendor should report the profit realized from the transaction as gross income for the latter year and that the small advance payment made in the earlier year should be treated as a return of capital since it was less than the cost of the property to the vendor and did not, therefore, constitute taxable income for the earlier year.[3]

Where a tract of land was sold on November 1, 1919, 1/10

[1] O. 988, Treasury Bulletin 8-20-751.

[2] O. D. 181, Treasury Bulletin 8-19-314.

[3] A. R. R. 13, Treasury Bulletin 2-20-671.

of the purchase price accompanying the bid, 4/10 being paid in December, 1919, and the balance in January, 1920, at which time a proper conveyance of title was delivered to the purchaser, the sale should be treated as a cash transaction for 1919 and the entire profit realized be returned as income for that year.[4] Where an individual sold real estate receiving in the year of sale over 1/4 of the total selling price, the contract providing that the balance should be paid in four annual installments thereafter, such deferred payments being secured by crop mortgages and additional collateral security, it has been held that the payments received in the year of sale were sufficiently substantial in amount to require the vendor to report in that year the entire profit realized on the sale.[5] Where an individual sold real estate which was mortgaged to secure a loan made by a State, the vendor agreeing to make payment partly in cash, assumed payment of the mortgage held by the State and gave the vendor a mortgage to cover the balance of the sale price, it has been held that the vendor has received the full amount of the sale price in cash or its equivalent and should report the entire profit realized as income for the year in which the sale was consummated, notwithstanding that the State refused to accept the vendee's promise to pay in lieu of the vendor's original liability for payment of the note in case of default by the vendee.[6]

[4] O. D. 568, Treasury Bulletin 27-20-1037.
[5] O. D. 569. Treasury Bulletin 27-20-1038.
[6] O. D. 409, Treasury Bulletin 11-20-784.

CHAPTER 18.

INCOME FROM INTEREST, RENT AND ROYALTIES

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TAX EXEMPTIONS OF LIBERTY BONDS AND VICTORY NOTES. The amount of interest upon Liberty bonds of any particular loan exempt from surtax and war-profits and excess-profits tax is in no case based on the amount of bonds of that loan subscribed for and still held at the time of filing the return. However, the conditional exemption of interest upon Liberty bonds of other loans by reason of original subscription and continued holding of Liberty bonds of the Fourth loan, or Victory notes, is based upon the amount of Liberty bonds of the Fourth loan and Victory notes originally subscribed for and still held by the taxpayer at the time of filing his return.[1] The words "the date of the tax return" as used in the supplement to the Second Liberty Loan Act are held to mean the date on which the return is filed with the collector. Consequently a taxpayer holding the prescribed amount of fourth Liberty loan bonds on December 31, 1918, but who disposes of them on January 1, 1919, before his return has been filed, is not allowed the exemption referred to.[2] An individual who inherits Fourth Liberty Loan bonds or Victory Loan notes which were originally subscribed for by the decedent is not entitled to the collateral exemption of interest on bonds of previous issues to which the decedent as the original subscriber would have been entitled.[3] Where a taxpayer has held at any time or times, within the taxable year Liberty loan bonds (any issues except the first unconverted), United States certificates of indebtedness, or war savings stamps, the total interest received being equal to or in excess of the interest for one year on an aggregate principal of $5,000, credit may be taken to an

[1] O. D. 493, Treasury Bulletin 19-20-913.
[2] O. D. 213, Treasury Bulletin 11-19-375.
[3] O. D. 405, Treasury Bulletin 8-20-752.

amount not exceeding such amount of interest for one year on the aggregate principal of $5,000.[4] In case a taxpayer converts his Liberty bonds or Victory notes originally subscribed for from one denomination into another, or from registered bonds into coupon bonds or vice versa, he may be considered the original subscriber to the new bonds or notes for the purpose of the collateral exemptions, if the new bonds or notes are of the same issue as the ones originally subscribed for.[5]

[4] O. D. 227, Treasury Bulletin 13-20-807.
[5] O. D. 718, Treasury Bulletin 45-20-1290.

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Footnote 12.
Add:—O. 781, Treasury Bulletin 1-19-116.

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WAR FINANCE CORPORATION BONDS. The exemption of $5,000 of principal amount on bonds of the War Finance Corporation is in addition to the $5,000 exemption allowed under the Liberty Loan Act of April 24, 1917, which amount includes Liberty bonds of any issue (excluding first), war savings certificates, and certificates of indebtedness.[1]

[1] O. D. 212, Treasury Bulletin 11-19-374.

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CERTIFICATES OF INDEBTEDNESS ISSUED BY DIRECTOR GENERAL OF RAILROADS. Certificates of indebtedness issued by the Director General of Railroads are held to be obligations of the United States but not such obligations as are exempt from income, war-profits, and excess-profits taxes.[1]

[1] O. D. 206. Treasury Bulletin 10-19-356.

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LIBERTY BONDS HELD BY BANKS. The excess of the amount of bonds purchased by a bank from the Government over the amount of such bonds subscribed for by the customers through the bank during the respective periods designated by the Government for receiving subscriptions is to be regarded as being the amount of principal of bonds originally subscribed for by

the bank for its own investment. Such bonds are to be listed in the return of the bank as property of the bank and the interest on such bonds is taxable income to the bank except to the extent provided in the Liberty loan acts and the supplements thereto. The bonds subscribed for by the customers during the subscription periods on which no default has occurred are to be deemed the property of the customers and are not to be listed in the return of the bank and the interest received from the Government on account of such bonds is not to be returned by the bank as income, but is to be reported in the returns of the customers. The amount of interest received by the bank from its customers on account of bonds carried for them (including the amount represented by any coupons retained by the bank by way of adjustment of accrued interest) constitutes taxable income to the bank, and no part of such interest is exempt from tax inasmuch as it is not interest on obligations of the United States but is interest on money advanced to the customers.[1] A bank which takes over Liberty bonds after default by individual subscribers can not be considered an original subscriber to such bonds.[2] In cases where there have been a great many changes in the amount of Liberty bonds of the various classes, or other securities of the United States, held by a bank during the year, it will be permissible to determine the amount of interest derived from each class, in excess of the maximum exemption applicable from the books or other records of the bank. The correct amount of interest, subject to tax, received or accrued, must be shown and a statement attached to the return showing how the interest was determined.[3]

[1] O. D. 192, Treasury Bulletin 8-19-331; O. D. 16, Treasury Bulletin 1-19-28.

[2] T. B. R. 28, Treasury Bulletin 6-19-271.

[3] O. D. 31, Treasury Bulletin 1-19-43.

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Obligations of the Possessions of the United States. The interest from bonds issued by the people of Porto Rico is exempt.[1] Interest on certificates of indebtedness issued by the

[1] O. D. 368, Treasury Bulletin 3-20-684.

Philippine Government is exempt.[2] Bonds issued by the military government of Santo Domingo in behalf of and payable from the revenues of the Dominican Republic while that country was under temporary military occupation by the United States are not obligations of the United States or of a possession of the United States.[3]

[2] O. D. 34, Treasury Bulletin 1-19-46.
[3] O. D. 420, Treasury Bulletin 13-20-807.

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Interest on the Obligations of States. When a city acquires property for park purposes by condemnation proceedings and pays for it by special assessments upon the districts considered to be specially benefited by the proposed improvement, assessments being payable in installments over a period of 10 years, and in order to obtain funds with which immediately to compensate the owners of the property condemned, the city issues "park fund certificates" in the nature of 10-year bonds, payable out of the assessments collected, such park fund certificates are obligations of the municipality, a political subdivision of the State, and the interest paid thereon by the city in behalf of the legally authorized assessment districts under its control is not subject to tax.[1]

Interest received on certificates of indebtedness known as fire relief certificates, issued in the State of Minnesota, is considered interest upon the obligations of a State and not taxable.[2]

[1] O. D. 491, Treasury Bulletin 19-20-911.
[2] O. D. 30, Treasury Bulletin 1-19-42.

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POLITICAL SUBDIVISION OF A STATE. Where in some of the western States irrigation districts are created by an election duly called for the purpose, the county assessor assessing all property benefited on the assessment rolls of the county and collecting a tax thereon in the same manner as other taxes are collected, it is held that such districts are political subdivisions of a State and interest on their bonds is exempt.[1]

[1] O. D. 544, Treasury Bulletin 24-20-1000.

Bonds issued by a municipality for public purposes in accordance with the general city charter law of the State to cover deferred installments of assessments against real estate for the cost of certain public improvements, the bonds being a lien upon all the property benefited to the extent of unpaid assessments and interest thereon and containing recitals that they are chargeable only to the particular property described therein, are held to be obligations of a political subdivision of a State, notwithstanding they were not a general liability of the city.[2] Certificates of sale issued by a county or other political subdivision of a State in connection with the sale of property for non-payment of taxes are not obligations of a State or political subdivision thereof.[3]

Interest on a claim against a city, recovered by a judgment several years after the claim accrued, is held to be interest on the obligation of a political subdivision of a state and, therefore, exempt.[4]

[2] O. D. 447, Treasury Bulletin 15-20-843.
[3] O. D. 327, Treasury Bulletin 28-19-611.
[4] O. D. 591, Treasury Bulletin 29-20-1071.

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Accrued Interest on Obligations at Time of Purchase. The burden is on the taxpayer to show what part of moneys paid or received by him on account of a transaction involving the sale or purchase between interest dates of interest-bearing obligations should be allocated to capital investment and what part to accrued interest. In the absence of such showing, the construction most favorable to the Government should be adopted. The rule stated in this paragraph of the 1920 edition does not apply to coupons detached from bonds and negotiated, which themselves, after being detached, become non-interest-bearing negotiable securities. If such coupons are detached and sold, and resold, they lose their character as interest and become capital. Dealings in them are to be treated as dealings in other capital assets, and profit and loss computed accordingly.[1]

[1] Sol. Op. 46, Treasury Bulletin 37-20-1191.

In the case of Treasury certificates of indebtedness which are offered by the Government at par and accrued interest and not at a discount, only the coupon interest can be considered exempt from normal tax, and from surtax to the extent provided by the Act approved September 24, 1917.[2]

[2] O. D. 729, Treasury Bulletin 46-20-1303.

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Bond Interest Paid in Scrip. Where a corporation which defaulted in the payment of its bond interest was reorganized, and the new corporation issued scrip, payable at certain fixed dates, and bearing interest at 6%, in exchange for the coupons representing the defaulted interest, such scrip is held to be the equivalent of cash and taxable as interest in the hands of the recipient.[1]

[1] O. D. 563, Treasury Bulletin 26-20-1032.

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Interest on Bonds Purchased at a Premium. Interest received or accrued on bonds purchased at a premium, according to the method employed in keeping books, represents income for the year in which received or accrued at the rate carried by the bonds and not at the rate which would be realized after amortizing the premium.[1]

[1] O. D. 622, Treasury Bulletin 32-20-1117.

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Discount. The excess of the face value of a so-called bank acceptance as collected at its maturity, over the amount paid therefor by a person collecting the acceptance at maturity, is not interest, but is taxable income when the face value of the acceptance is collected.[1]

Profit derived from noninterest-bearing State and municipal securities purchased at a discount and held until maturity is not taxable where it clearly appears that the return from the investment in the hands of the taxpayer is due solely to the compensation received from the State or municipality in lieu of interest for the use of the taxpayer's money. In no case

[1] O. 1024, Treasury Bulletin 16-20-865.

may such exemption exceed the total discount at which the securities were originally sold by the State or municipality.[2]

[2] O. D. 647, Treasury Bulletin 35-20-1166, reversing O. D. 238, Treasury Bulletin 13-20-416.

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Interest Accruing Prior to March 1, 1913. Where a farm was sold in 1910 under a contract calling for annual payments of principal and interest for 10 years, a deed being given in 1919, and the unpaid purchase price being secured by notes, it has been held that payments of principal received subsequent to 1910 are not subject to tax, but that for the years in which income tax laws have been in force, the vendor should have included as income any interest received which accrued subsequent to February 28, 1913, on deferred payments. Likewise he should report the interest received on the notes given for the balance of the purchase price in 1919.[1]

[1] O. D. 646, Treasury Bulletin 35-20-1165. The English courts have followed the same rule in dealing with such contracts; see Hudson's Bay Co. v. Thew, Gt. Br. Tax Cases, Vol. VII, Pt. II, p. 206.

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Footnote 36.

The same principle was applied by the court under the 1909 Law. (Northern Pacific Railway Co. v. Lynch, U. S. Dist. Ct., Dist. of Minnesota; T. D. 3048, Treasury Bulletin 32-20-1122.)

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VALUE OF IMPROVEMENTS MADE BY TENANT. The Treasury Department has modified its previous ruling that improvements made by a tenant are income to the lessor at the expiration or termination of the lease and has now ruled that when buildings are erected or improvements are made by a lessee in pursuance of an agreement with the lessor, and such buildings or improvements are not subject to removal by the lessee, the lessor receives income at the time when such buildings or improvements are completed, to the extent of the fair market price or value of such buildings or improvements subject to the lease. This amount would ordinarily be the difference between the value of the land free from the lease without such

improvements and the value of the land subject to the lease with such improvements. If, for any other reason than a bona fide purchase from the lessee by the lessor, the lease is terminated, so that the lessor comes into possession and control of the property prior to the time originally fixed for the termination of the lease, the lessor receives additional income for the year in which the lease is so terminated to the extent that the value of such buildings or improvements when he became entitled to such possession exceeds the fair market price or value thereof to him as determined when the same completed became part of the realty. No appreciation in value due to causes other than the premature termination of the lease shall be included. Conversely, if the buildings or improvements are destroyed prior to the termination of the lease the lessor is entitled to deduct as a loss of the year when such destruction takes place the fair market price or value of such buildings or improvements subject to the lease as determined when the same completed became a part of the realty, or the value thereof subject to the lease on March 1, 1913, less any salvage value subject to the lease, to the extent that such loss was not compensated by insurance.[1]

[1] T. D. 3062, Treasury Bulletin 37-20-1198, amending Reg. 45, Arts. 48, 109 and 164. See also Cryan v. Wardell, 263 Fed. 248.

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Footnote 40.

Add:—T. D. 3062, Treasury Bulletin 37-20-1198, amending Reg. 45, Arts. 48, 109 and 164.

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Footnote 44.

Add:—Stratton's Independence v. Howbert, 231 U. S. 399, 34 Sup. Ct. 136. For a thorough discussion of the cases of Von Baumbach v. Sargent Land Co., 242 U. S. 503, 37 Sup. Ct. 201; U. S. v. Biwabik Mining Co., 247 U. S. 116, 38 Sup. Ct. 462, and Stratton's Independence v. Howbert, 231 U. S. 399, 34 Sup. Ct. 136, see the discussion of the subject of depletion by lessees under prior laws in this supplement referring to page 453 of the 1920 edition. This discussion will throw light upon the subject matter of royalties from mines.

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Royalties. When land purchased in 1914 and having no mineral rights value at the time of purchase, is subsequently leased on a royalty basis for oil and gas development, amounts received from the sale of interests in such royalty have been held to be income for the year of receipt, subject to proper adjustment on account of depletion sustained.[1]

[1] O. D. 644, Treasury Bulletin 35-20-1163.

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ROYALTIES FROM MINES. It has been held under the 1913 and 1916 Laws that a Pennsylvania mining lease containing the provisions indicated in the footnote below does not constitute a sale of the coal in place and that royalties received thereunder are income to the lessors.[1]

[1] S. 1365, Treasury Bulletin 18-20-900. The provisions of the lease under consideration were as follows:

(1) To demise, lease and let to the lessee all coal in, upon and under certain lands owned by the lessor.

(2) The lessee was given the right to mine, remove, and dispose of the coal.

(3) The lessor retained the privilege at any time after the expiration of the first 10 years of the lease to sell the leased property upon giving 6 months' notice to the lessee and affording the lessee an opportunity to purchase the property.

(4) The lease was not to be assigned by the lessee without the consent of the lessor.

(5) The lessor retained absolutely the right to sell the property subject to the terms of lease.

Upon termination of this lease, a new lease agreement was made containing, among other provisions, the following:

(1) Term of lease, 10 years.

(2) Lessee to mine and remove as much coal as possible by reasonably diligent mining operations.

(3) The lessee agreed not to assign the lease without consent of the lessor, but had the right to sublet portions of the surface without consent of the lessor.

(4) Upon failure of the lessee to comply with all conditions of the agreement, the lessor had the right to declare a forfeiture of the unexpired portion of the lease.

CHAPTER 19.

INCOME FROM DIVIDENDS

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Definitions. Preferred stockholders whose dividends are in arrears have no enforceable claim against the corporation unless and until a dividend be declared by the directors and consequently are not "creditors". A payment or settlement pursuant to the compromise by corporate directors of accumulated dividends on preferred stock, the payment or settlement consisting partly of cash, partly of shares of preferred stock, and partly shares of common stock, has been held to be a dividend within the meaning of the Massachusetts Income Tax Law, since the money and stock are paid from or based upon earnings.[1]

[1] Wilder v. Trefry (Mass.), 125 N. E. 689.

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DISTRIBUTION IN LIQUIDATION. A distribution of earnings or profits prior to any vote or resolution providing for liquidation is an ordinary, not a liquidating, dividend, even though the stockholders subsequently vote to go into liquidation and to distribute remaining capital.[1]

Where the assets of a corporation in process of liquidation are being disposed of, the proceeds being distributed to the stockholders in installments, and it is not known what the total proceeds will be, and consequently the amount of profit to the stockholders can not be definitely determined, a stockholder should return no portion of the installment payments as income until the amount actually received exceeds the cost of the stock to him, or its fair market value as at March 1, 1913, if acquired prior to that date. However, if the corporation enters into a contract for the sale of its assets at a stipulated

[1] A. R. M. 93, Treasury Bulletin 47-20-1309. See discussion in footnote 13, page 294, of 1920 edition.

price, the purchaser making payment in installments, the portion of each liquidating payment to the stockholder representing profit is determinable and should be returned as income for the year during which received.[2]

In a case in which a corporation assigned its principal asset (a mortgage payable in annual instalments with interest) to trustees in trust for its stockholders and then instituted liquidation proceedings, the beneficiaries under the trust receiving proportionate shares of principal and interest as paid to the trustees, it has been held that the profit of the stockholders from the surrender of their stock was not definitely ascertainable and that no amount was required to be reported as income until the total sum received in liquidation exceeded either the cost of the stock to the stockholders or its fair market value as of March 1, 1913, if acquired prior to that date.[3]

[2] O. D. 343, Treasury Bulletin 30-19-635.

[3] O. D. 461, Treasury Bulletin 16-20-874.

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RETIREMENT OF CAPITAL STOCK. Payments by a corporation to its stockholders in retiring its own stock are not dividends within the meaning of the statute if the liquidation is in pursuance of an obligation arising out of the stock contract, unless it appears that the corporation has an option of distributing its assets with a debit to capital stock account or to surplus account. Any excess received by the stockholders upon such retirement over the cost of the stock or its fair market value as of March 1, 1913, if acquired prior thereto, will be a taxable profit.[1] In a recent case in which a corporation retired twice the amount of additional stock previously issued in connection with the performance of government contracts during the war, the amount representing the par value of the stock being charged to capital account and an excess over par value paid by the corporation to retire the stock being charged to surplus accumulated prior to March 1, 1913, it has been held that the distribution was not a dividend within the meaning

[1] O. D. 360, Treasury Bulletin 2-20-667. Such profit will probably be held liable to the normal tax as well as the surtax.

of the statute but was a distribution in part liquidation. Any excess over the cost or fair market value of the stock as of March 1, 1913, if acquired prior thereto, was held to be subject to the normal tax and the surtax in the hands of the stockholders.[2]

[2] O. D. 479, Treasury Bulletin 18-20-891. See also O. D. 488, Treasury Bulletin 19-20-908.

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Footnote 13.

Add.—A. R. R. 67, Treasury Bulletin 17-20-877. The Treasury Department has held to the same effect under the 1916 Law. (See S. 971, Treasury Bulletin 2-19-141; T. B. R. 71, Treasury Bulletin 22-19-530.)

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DIVIDENDS IN THE FORM OF ROYALTIES. A royalty paid by a corporation to one of its officers, who is also majority stockholder, for the use of a patent upon an article manufactured and sold by the corporation, if in excess of a reasonable amount, taking into consideration all the facts in the particular case, will represent a distribution of profits and will be taxable to the recipient as dividends.[1]

[1] O. D. 440, Treasury Bulletin 14-20-835.

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Footnote 26.

A cash dividend paid in 1916 by a subsidiary to a parent corporation was taxable to the extent that it was paid from surplus earned after March 1, 1913 (T. B. R. 45, Treasury Bulletin 15-19-442) provided there was no relationship or identity between the parent and subsidiary corporations of the character indicated in Southern Pacific Co. v. Lowe, 247 U. S. 330, 38 Sup. Ct. 540, and Gulf Oil Corp. v. Lewellyn, 248 U. S. 71, 39 Sup. Ct. 35. (See also Loomis v. Wattles, 266 Fed. 876.) It has been held under Section 31 (b) of the 1916 Law, as amended, that such Section does not differentiate between corporate and individual stockholders and that distributions to a domestic corporation, a stockholder in a foreign corporation deriving no income from sources within the United States during the year 1917, of profits or surplus accumulated by such foreign corporation prior to the year 1917 are not taxable to the domestic corporation at the rates prescribed for the year 1917 but are taxable at the rates prescribed for the years in which such profits or surplus were accumulated, or if accumulated prior to March

1, 1913, were not subject to tax. The same ruling holds that such dividends were not subject to the 1917 excess-profits tax. (T. B. R. 60. Treasury Bulletin 21-19-520.)

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Presumption as to Source of Distribution. The statute makes no provision for the taxation of cash dividends, no matter when received at any rates other than those in force for the taxable year. The sixty-day presumption applies to the determination of invested capital alone.[1] The first 60 days of any taxable year includes March 1, except during a leap year.[2]

[1] A. R. R. 127, Treasury Bulletin 23-20-992; O. D. 5, Treasury Bulletin 1-19-9. This conclusion is strengthened by the fact that in subdivision (d) of section 201 *stock* dividends are made taxable at the rates prescribed for the years in which the corporation accumulated the earnings so distributed.

[2] O. D. 4, Treasury Bulletin 1-19-8.

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Dividends from Earnings or Profits Accumulated Prior to March 1, 1913. If a corporation has had earnings in any year since March 1, 1913, a dividend will be deemed to be out of such earnings even though such earnings have been more than offset by subsequent losses so that there has been a net operating deficit since March 1, 1913.[1]

Where a corporation has profits accumulated prior to March 1, 1913, but none accumulated between that date and January 1, 1918, and pays dividends during the first 60 days of 1918, such dividends will be deemed to have been paid from earnings or profits accumulated after December 31, 1917.[2]

In a case in which in 1919 a corporation paid three deferred

[1] O. D. 610, Treasury Bulletin 31-20-1098; T. B. R. 43, Treasury Bulletin 12-19-395. The Treasury Department construes the phrase "profits accumulated" to mean profits which have been earned and not dissipated by subsequent losses. (A. R. M. 82, Treasury Bulletin 40-20-1219.)

[2] T. B. R. 43, Treasury Bulletin 12-19-395. The effect of this ruling is to subordinate subdivision (e) of section 201 to subdivision (b), the former, together with subdivision (d), providing for the *method* and *rate* of taxation and the latter for *liability* to taxation.

dividends on its outstanding first preferred stock, the dividends being those due February 1 and August 1, 1910, and February 1, 1911, the actual surplus necessary to pay them having accumulated prior to December 31, 1911, it was claimed that the terms of issue of the stock prescribed when the dividends became due, the company merely having the privilege of deferring payment; and that it was the understanding of the officers of the company that its surplus was held to pay past due dividends. The stock certificates contained a provision in accordance with which the deferred dividends were paid and the stock redeemed. It was held that the three deferred dividends would be considered to have been paid out of earnings and profits accumulated since February 28, 1913, unless it could be shown that all earnings and profits accumulated since that date were first distributed. If this could not be shown, the distribution constituted income to the recipient stockholders subject to surtax but not to the normal tax.[3]

As a result of the recent stock dividend decision[4] holding that stock dividends do not constitute a distribution of earnings of the corporation, the Treasury Department has ruled that a stock dividend issued as the result of the transfer of earnings accumulated subsequent to February 28, 1913, to capital account or other bookkeeping procedure equivalent thereto, is not a distribution in accordance with the Revenue Act of 1918,[5] or previous income tax statutes, and the presumptive allocation as to earnings distributed will be held not to apply to such stock dividend; hence, a dividend paid in cash by the company will be deemed to represent a distribution of its earnings or surplus accumulated since February 28, 1913, and remaining undistributed at the date of payment within the meaning of the statute as affected by the decision mentioned, regardless of the issuance by the corporation of any stock dividends since February 28, 1913, and prior to the date of payment of the cash dividend. Where a corporation, having a surplus accumulated in part prior to March 1, 1913, and

[3] O. D. 488, Treasury Bulletin 19-20-908.

[4] Eisner v. Macomber, 252 U. S. 189.

[5] Section 201.

being thereunto lawfully authorized, transfers to its capital account a portion of its surplus, issues new stock representing the amount so transferred to the capital account and then declares a dividend payable in part in cash and in part in shares of the new issue of stock, that portion of the dividend paid in cash will be deemed to have been paid out of surplus accumulated since February 28, 1913, to the extent of the earnings and profits accumulated since that date, and is subject to tax, but the portion of the dividend paid in stock will not be subject to tax as income.[6]

[6] O. D. 587, Treasury Bulletin 29-20-1065.

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Footnote 30.

The case of Lynch v. Turrish, 247 U. S. 221, has been followed by the court in Stoffregen v. Moore, 264 Fed. 232, and in U. S. v. Philadelphia B. & W. R. Co., 262 Fed. 188.

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BOOK ENTRIES. Where original entries on the books and records of a corporation show that a dividend paid prior to August 6, 1917, represented a distribution of earnings accumulated prior to March 1, 1913, the dividend is exempt from income tax even though it was not specifically stated in the resolution authorizing payment of the dividend that it was to be paid from such earnings.[1]

[1] O. D. 655, Treasury Bulletin 36-20-1180.

[Page 303.]

Footnote 32.

Add:—Contra, State ex rel. Moon v. Nygaard (Wis.), 175 N. W. 810, decided under the Wisconsin statute.

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Distributions of Capital. It has been held that a dividend declared and paid by a corporation which was in part illegal because in excess of true earnings, and which dividend was later rescinded by the corporation, was not taxable as income to the stockholders to the extent that the corporation had a

legal right to force rescission and repayment and to the extent that such rescission and repayment were actually made.[1] It has been held that a dividend will be deemed to have been paid out of current earnings to the extent possible and taxable to the recipient accordingly, notwithstanding that there was an actual impairment of capital and the books show an apparent surplus based on an arbitrary valuation of goodwill, trade marks, etc.[2]

Where the principal stockholder paid in to a corporation a sum of money for which no stock was issued and on which no interest was charged, it being entered upon the company's books as a contribution of capital and never treated as an account payable, the repayment of this sum to the stockholder will be deemed to be out of undivided profits or earned surplus so far as possible and cannot be treated as a return of capital, unless the undivided profits and earned surplus accumulated since 1913 have been first distributed as dividends.[3]

[1] T. B. M. 77, Treasury Bulletin 20-19-502.

[2] O. D. 163, Treasury Bulletin 6-19-266. This ruling seems to violate the fundamental rule that book entries are only evidential and are not conclusive (See Doyle v. Mitchell, 247 U. S. 179). If the dividend in question was in fact a distribution of capital, it should be free from tax notwithstanding any "apparent" surplus based on arbitrary valuations. This is practically the effect of T. D. 2734 in which it was held (when a stock dividend was considered taxable) that stock dividends created from a revaluation of capital assets or to represent value placed upon trade marks, goodwill, etc., were not taxable to the shareholder.

[3] T. B. M. 82, Treasury Bulletin 23-19-552.

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Dividends Taxable in Year Received. In a recent case suit was brought by the stockholders of a corporation in 1917 to compel the corporation to distribute accumulated cash surplus, as a result of which the court ordered the distribution made, with interest from the date of the decree. The corporation took no steps to comply with this order, and no dividend was declared and no amount made available to the stockholders, but the company appealed the case. The judgment of the lower court was not affirmed by the higher court until Febru-

ary, 1919, at which time the amounts in question were distributed to the stockholders.

The Treasury Department held that no amounts became available to the stockholders as income until the judgment of the lower court was affirmed in 1919.[1] Since the date of payment rather than the date of receipt is the governing factor in determining when a dividend should be treated as taxable income, a dividend paid in Missouri and received there by stockholders on December 30, 1917, but not received by stockholders in California until January, 1918, will be taxable in the 1917 returns to the California stockholders.[2] A stockholder who has received payments from a corporation because of his stock ownership therein, which payments were not subject to a formal declaration of dividends and which were not then entered on the books against surplus accrued prior to March 1, 1913, is taxable with respect to such distribution of corporate profits as dividends. The formal declaration of such dividends by the directors at a date one year after the dividends had been paid and subsequent entries made on the corporate books, do not have the effect of relieving the taxpayer of tax on such dividends.[3] In such case the informal distribution was held to be a dividend within the meaning of the 1916 law.[4]

[1] A. R. R. 124, Treasury Bulletin 25-20-1012.

[2] O. D. 97, Treasury Bulletin 2-19-140.

[3] O. 932, Treasury Bulletin 25-19-579.

[4] See Spencer v. Lowe, 198 Fed. 961; Huntley v. Pioneer Iron Works, 181 N. Y. 73.

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DIVIDENDS PAID IN PROPERTY. Where a national bank utilized a portion of its undivided profits in the creation of a savings bank and trust company, the stock of said savings bank and trust company being issued in the names of trustees for all shareholders of the national bank, and the certificates of stock of the national bank showing on the face thereof that the holders are entitled to their pro rata share of the capital stock of the savings bank and trust company, the stockholders

will be deemed to have received a dividend in specie and will be liable for tax on the value of certificates of stock in the new corporation received by them.[1]

[1] O. D. 152, Treasury Bulletin 5-19-243.

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SCRIP DIVIDENDS. Where an insurance company issues certificates of profit based upon premiums received on marked off risks of the previous year, such certificates maturing in six years and subject to future losses and expenses until redeemed, interest being payable annually upon their face value, it has been held that such certificates are in the nature of scrip dividends. Inasmuch as they might be affected by gains or losses of the company during their maturing period, the certificates should not be accounted for until the taxable year in which they mature or are redeemed. The amount of interest payable annually on the certificates constitutes taxable income for the year in which it is received.[1]

[1] O. D. 589, Treasury Bulletin 29-20-1067.

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Footnote 38.

Add:—O. D. 471, Treasury Bulletin 17-20-883; T. D. 3052, Treasury Bulletin 33-20-1141.

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Stock Dividends. The decision of the Federal District Court referred to in the 1920 edition, holding that the provision of the 1916 Law, by which stock dividends were in terms stated to be income and to be taxable as such to the same extent as cash dividends, was unconstitutional, has now been affirmed by the United States Supreme Court.[1] In this case the United States Supreme Court clearly holds that from every point of view, neither under the Sixteenth Amendment nor otherwise, has Congress power to tax without apportionment a true stock dividend made lawfully and in good faith, or the accumulated profits behind it, as income of the stockholder. For this reason the Revenue Act of 1916, insofar as it imposes

[1] Eisner v. Macomber, 252 U. S. 189, decided March 8, 1920.

a tax upon a stockholder because of such dividend, is held to violate the provisions of Article 1, Section 2, Clause 3, and Article 1, Section 9, Clause 4 of the Federal Constitution. This decision of the Supreme Court is of so great importance that it is deemed advisable to quote somewhat at length from the Court's opinion as follows:

"Certainly the interest of the stockholder is a capital interest, and his certificates of stock are but the evidence of it. They state the number of shares to which he is entitled and indicate their par value and how the stock may be transferred. They show that he or his assignors, immediate or remote, have contributed capital to the enterprise, that he is entitled to a corresponding interest proportionate to the whole, entitled to have the property and business of the company devoted during the corporate existence to attainment of the common objects, entitled to vote at stockholders' meetings, to receive dividends out of the corporation's profits if and when declared, and, in the event of liquidation, to receive a proportionate share of the net assets, if any, remaining after paying creditors. Short of liquidation, or until dividend declared, he has no right to withdraw any part of either capital or profits from the common enterprise; on the contrary, his interest pertains not to any part, divisible or indivisible, but to the entire assets, business, and affairs of the company. Nor is it the interest of an owner, since the corporation has full title, legal and equitable, to the whole. The stockholder has the right to have the assets employed in the enterprise, with the incidental rights mentioned; but, as stockholder, he has no right to withdraw, only the right to persist, subject to the risks of the enterprise, and looking only to dividends for his return. If he desires to disassociate himself from the company he can do so only by disposing of his stock.

For bookkeeping purposes, the company acknowledges a liability in form to the stockholders equivalent to the aggregate par value of their stock, evidenced by a "capital stock account." If profits have been made and not divided they create additional bookkeeping liabilities under the head of "profit and loss," "undivided profits," "surplus account," or the like. None

of these, however, gives to the stockholders as a body, much less to any one of them, either a claim against the going concern for any particular sum of money, or a right to any particular portion of the assets or any share in them unless or until the directors conclude that dividends shall be made and a part of the company's assets segregated from the common fund for the purpose. The dividend normally is payable in money, under exceptional circumstances in some other divisible property; and when so paid, then only (excluding, of course, a possible advantageous sale of his stock or winding-up of the company) does the stockholder realize a profit or gain which becomes his separate property, and thus derive income from the capital that he or his predecessor has invested.

In the present case, the corporation had surplus and undivided profits invested in plant, property, and business, and required for the purposes of the corporation, amounting to about $45,000,000, in addition to outstanding capital stock of $50,000,000. In this the case is not extraordinary. The profits of a corporation, as they appear upon the balance sheet at the end of the year, need not be in the form of money on hand in excess of what is required to meet current liabilities and finance current operations of the company. Often, especially in a growing business, only a part, sometimes a small part, of the year's profits is in property capable of division; the remainder having been absorbed in the acquisition of increased plant, equipment, stock in trade, or accounts receivable, or in decrease of outstanding liabilities. When only a part is available for dividends, the balance of the year's profits is carried to the credit of undivided profits, or surplus, or some other account having like significance. If thereafter the company finds itself in funds beyond current needs it may declare dividends out of such surplus or undivided profits; otherwise it may go on for years conducting a successful business, but requiring more and more working capital because of the extension of its operations, and therefore unable to declare dividends approximating the amount of its profits. Thus the surplus may increase until it equals or even exceeds the par value of the outstanding capital stock. This may be adjusted upon

the books in the mode adopted in the case at bar—by declaring a "stock dividend". This, however, is no more than a book adjustment, in essence not a dividend but rather the opposite; no part of the assets of the company is separated from the common fund, nothing distributed except paper certificates that evidence an antecedent increase in the value of the stockholder's capital interest resulting from an accumulation of profits by the company, but profits so far absorbed in the business as to render it impracticable to separate them for withdrawal and distribution. In order to make the adjustment, a charge is made against surplus account with corresponding credit to capital stock account, equal to the proposed "dividend"; the new stock is issued against this and the certificates delivered to the existing stockholders in proportion to their previous holdings. This, however, is merely bookkeeping that does not affect the aggregate assets of the corporation or its outstanding liabilities; it affects only the form, not the essence, of the "liability" acknowledged by the corporation to its own shareholders, and this through a readjustment of accounts on one side of the balance sheet only, increasing "capital stock" at the expense of "surplus"; it does not alter the pre-existing proportionate interest of any stockholder or increase the intrinsic value of his holding or of the aggregate holdings of the other stockholders as they stood before. The new certificates simply increase the number of the shares, with consequent dilution of the value of each share.

A "stock dividend" shows that the company's accumulated profits have been capitalized, instead of distributed to the stockholders or retained as surplus available for distribution in money or in kind should opportunity offer. Far from being a realization of profits of the stockholder, it tends rather to postpone such realization, in that the fund represented by the new stock has been transferred from surplus to capital, and no longer is available for actual distribution.

The essential and controlling fact is that the stockholder has received nothing out of the company's assets for his separate use and benefit; on the contrary, every dollar of his original investment, together with whatever accretions and accu-

mulations have resulted from employment of his money and that of the other stockholders in the business of the company, still remains the property of the company, and subject to business risks which may result in wiping out the entire investment. Having regard to the very truth of the matter, to substance and not to form, he has received nothing that answers the definition of income within the meaning of the Sixteenth Amendment.

Being concerned only with the true character and effect of such a dividend when lawfully made, we lay aside the question whether in a particular case a stock dividend may be authorized by the local law governing the corporation, or whether the capitalization of profits may be the result of correct judgment and proper business policy on the part of its management, and a due regard for the interests of the stockholders. And we are considering the taxability of *bona fide* stock dividends only.

We are clear that not only does a stock dividend really take nothing from the property of the corporation and add nothing to that of the shareholder, but that the antecedent accumulation of profits evidenced thereby, while indicating that the shareholder is the richer because of an increase of his capital, at the same time shows he has not realized or received any income in the transaction.

It is said that a stockholder may sell the new shares acquired in the stock dividend; and so he may, if he can find a buyer. It is equally true that if he does sell, and in doing so realizes a profit, such profit, like any other, is income, and so far as it may have arisen since the Sixteenth Amendment is taxable by Congress without apportionment. The same would be true were he to sell some of his original shares at a profit. But if a shareholder sells dividend stock he necessarily disposes of a part of his capital interest, just as if he should sell a part of his old stock, either before or after the dividend. What he retains no longer entitles him to the same proportion of future dividends as before the sale. His part in the control of the company likewise is diminished. Thus, if one holding $60,000 out of a total $100,000 of the capital stock in a corporation

should receive in common with other stockholders a 50 per cent. stock dividend, and should sell his part, he thereby would be reduced from a majority to a minority stockholder, having six-fifteenths instead of six-tenths of the total stock outstanding. A corresponding and proportionate decrease in capital interest and in voting power would befall a minority holder should he sell dividend stock; it being in the nature of things impossible for one to dispose of any part of such an issue without a proportionate disturbance of the distribution of the entire capital stock, and a like diminution of the seller's comparative voting power—that "right preservative of rights" in the control of a corporation. Yet, without selling, the shareholder, unless possessed of other resources, has not the wherewithal to pay an income tax upon the dividend stock. Nothing could more clearly show that to tax a stock dividend is to tax a capital increase, and not income, than this demonstration that in the nature of things it requires conversion of capital in order to pay the tax.

Throughout the argument of the Government, in a variety of forms, runs the fundamental error already mentioned—a failure to appraise correctly the force of the term "income" as used in the Sixteenth Amendment, or at least to give practical effect to it. Thus, the Government contends that the tax "is levied on income derived from corporate earnings", when in truth the stockholder has "derived" nothing except paper certificates which, so far as they have any effect, deny him present participation in such earnings. It contends that the tax may be laid when earnings "are received by the stockholder", whereas he has received none; that the profits are "distributed by means of a stock dividend", although a stock dividend distributes no profits; that under the Act of 1916 "the tax is on the stockholder's share in corporate earnings", when in truth a stockholder has no such share, and receives none in a stock dividend; that "the profits are segregated from his former capital, and he has a separate certificate representing his invested profits or gains", whereas there has been no segregation of profits, nor has he any separate certificate representing a personal gain, since the certificates, new and old, are

alike in what they represent—a capital interest in the entire concerns of the corporation.

We have no doubt of the power or duty of a court to look through the form of the corporation and determine the question of the stockholder's right, in order to ascertain whether he has received income taxable by Congress without apportionment. But, looking through the form, we cannot disregard the essential truth disclosed; ignore the substantial difference between corporation and stockholder; treat the entire organization as unreal; look upon stockholders as partners, when they are not such; treat them as having in equity a right to a partition of the corporate assets, when they have none; and indulge the fiction that they have received and realized a share of the profits of the company which in truth they have neither received nor realized. We must treat the corporation as a substantial entity separate from the stockholder, not only because such is the practical fact but because it is only by recognizing such separateness that any dividend—even one paid in money or property—can be regarded as income of the stockholder. Did we regard corporation and stockholders as altogether identical, there would be no income except as the corporation acquired it; and while this would be taxable against the corporation as income under appropriate provisions of law, the individual stockholders, could not be separately and additionally taxed with respect to their several shares even when divided, since if there were entire identity between them and the company they could not be regarded as receiving anything from it, any more than if one's money were to be removed from one pocket to another.

Conceding that the mere issue of a stock dividend makes the recipient no richer than before, the Government nevertheless contends that the new certificates measure the extent to which the gains accumulated by the corporation have made him the richer. There are two insuperable difficulties with this: In the first place, it would depend upon how long he had held the stock whether the stock dividend indicated the extent to which he had been enriched by the operations of the company; unless he had held it throughout such operations the

measure would not hold true. Secondly, and more important for present purposes, enrichment through increase in value of capital investment is not income in any proper meaning of the term."

The above decision of the Supreme Court has been declared by the Treasury Department to sustain the following propositions of law.[2]

1. Where a corporation, being authorized so to do by the laws of the State in which it is incorporated, transfers a portion of its surplus to capital account, issues new stock representing the amount of the surplus so transferred, and distributes the stock so issued to its stockholders, such stock is not income to the stockholders and the stockholders incur no liability for income tax by reason of its receipt.

2. Where a corporation, being thereunto lawfully authorized, increases its capital stock, and simultaneously declares a cash dividend equal in amount to the increase in its capital stock, and gives to its stockholders a real option either to keep the money for their own or to reinvest it in the new shares, such dividend is a cash dividend and is income to the stockholders whether they reinvest it in the new shares or not.[3]

3. Where a corporation, which is not permitted under the laws of the State in which it is incorporated to issue a stock dividend, increases its capital stock and at the same time declares a cash dividend under an agreement with the stockholders to reinvest the money so received in the new issue of capital stock, such dividend is subject to tax as income to the stockholder.[4]

[2] T. D. 3052, Treasury Bulletin 33-20-1141.

[3] See also T. B. R. 42, Treasury Bulletin 12-19-398; O. D. 565, Treasury Bulletin 27-20-1034; T. B. R. 63, Treasury Bulletin 22-19-529.

[4] The same reasoning applies to national banks which are authorized by law to issue only cash dividends (see Instructions of the Comptroller of the Currency relative to the organization and powers of national banks for 1919, p. 56). Cash dividends declared by a national bank coupled with the right to apply the same to the purchase of an increase in capital stock are therefore not within the decision of Eisner v. Macomber and are subject to the surtax in the hands of the stockholder (O. D. 588, Treasury Bulletin 29-20-1066). It has been held that where an assessment of income tax has been treated by both parties in the

court below as an assessment on a stock dividend and has been so treated in the assessment of tax by the Commissioner, it cannot be upheld in the Circuit Court of Appeals as an assessment on a cash dividend although the corporation's surplus was distributed by check, which was endorsed by the stockholders in exchange for the stock, the assessment having been made on a value of the stock which was more than double the face of the check. The assessment must be made by the Commissioner and cannot be made by the court. (Loomis v. Wattles, 266 Fed. 876.)

4. Where a corporation, having a surplus accumulated in part prior to March 1, 1913, and being thereunto lawfully authorized, transfers to its capital account a portion of its surplus, issues new stock representing the amount so transferred to the capital account and then declares a dividend payable in part in cash and in part in shares of the new issue of stock, that portion of the dividend paid in cash will, to the amount of the surplus accumulated since March 1, 1913, be deemed to have been paid out of such surplus, and be subject to tax, but the portion of the dividend paid in stock will not be subject to tax as income.[5]

5. A dividend, paid in stock of another corporation held as a part of the assets of the corporation paying the dividend, is income to the stockholder at the time the same is made available for distribution to the full amount of the then market value of such stock; and if such stock be subsequently sold by the stockholder, the difference between its market value at date of receipt and the price for which it is sold is additional income or loss to him, as the case may be.

6. The profit derived by a stockholder upon the sale of stock received as a dividend is income to the stockholder and taxable as such even though the stock itself was not income at the time of its receipt by the stockholder. For the purpose of determining the amount of gain or loss derived from the sale of stock received as a dividend or of the stock with respect to which such dividend was paid, the cost of each share of stock (provided both the dividend stock and the stock with respect to which it is issued have the same rights and preferences) is the quotient of the cost of the old stock (or its fair

[5] See also O. D. 587, Treasury Bulletin 29-20-1065.

market value as of March 1, 1913, if acquired prior to that date) divided by the total number of shares of the old and new stock.[6]

It has been held that a taxpayer who in 1918 carried certain shares of stock in a corporation on a margin with a stock brokerage firm, such stock not being owned outright by the taxpayer and not being registered in his name, with respect to which stock a stock dividend was declared and paid to the brokerage firm (which distributed it to the marginal owners) should file a claim for credit or refund of the taxes paid on such stock dividend, with a statement from the paying corporation showing the number of shares of stock standing in the name of the brokerage firm and the amount of stock dividends paid to such firm during the year 1918; also a statement signed by the brokerage firm indicating the number of shares of the corporation's stock which the firm carried for his account and the amount of stock dividends paid over to him.[7]

In filing returns for prior years taxpayers reported dividends received, including both cash and stock dividends, without segregation. The taxpayer should present to the collector formally a claim for credit for any overpayment of taxes in prior years on the regular form for that purpose (Form 47A) and on this form must be set forth the full details of dividends received and taxes paid thereon. A claim for credit on Form 47A for payment of tax on stock dividends will be accepted as a suspension of immediate collection of tax due only—

(1) Against income or income and excess-profits taxes due and unpaid.

(2) If amount claimed as a credit does not exceed the amount of tax collected on the stock dividend less any additional tax due and unpaid upon the sale of stock received as a dividend or stock upon which the dividend was declared.

(3) When accompanied by an affidavit of the taxpayer (supported by statements from the corporation which distributed the dividends as to the amount distributed to the tax-

[6] See also O. D. 478, Treasury Bulletin 18-20-890.

[7] O. D. 625, Treasury Bulletin 32-20-1123.

payer and years in which the profits distributed were earned) covering the following information:

(a) Whether the dividend consists of stock of the corporation distributing the dividend to the taxpayer, or of stock of another corporation acquired by the distributor.

(b) The name of each corporation declaring, the declaration of, and the date of receipt by the taxpayer of, the stock dividends, the tax on which was paid and is covered by the claim.

(c) The year in which the stock dividend was included in the taxpayer's return of income.

(d) The number of shares the taxpayer received and the value placed upon the dividend in the return. (If no sale of stock was made, the taxpayer need not furnish the following information.)

(e) If any sale has been made of stock of the corporation declaring the dividends, whether the stock be that acquired by a dividend, or upon which the dividend was declared, there should be stated

(1) The number of shares sold.

(2) The selling price.

(3) The date or dates of sale.

(4) The portion, if any, of the selling price included as taxable profit in the return of net income for the year the sale was made and the item in the return under which the amount was reported.

(f) The number of shares of stock the taxpayer owned at the time he received the first stock dividend; how much that stock cost the taxpayer and the date the stock was acquired. (If acquired prior to March 1, 1913, its value on that date and manner of determining the value.)

(g) The dates stated separately from March 1, 1913, upon which stock dividends were received, the number of shares received on each date, and the names of the corporations distributing the dividends.

The receipt or canceled check covering the payment of tax involved in the claim should be attached to the claim. Taxpayers on complying with these requirements will be permitted

by the collectors to credit the amounts due them against any installment of taxes remaining unpaid. In case the credit to which the taxpayer is entitled exceeds the amount of taxes remaining unpaid, a claim for refund of the difference may be filed.[8]

[8] M. 2429 and M. 2436, Treasury Bulletin 11-20, pp. 16-7.

[Page 314.]

RULE UNDER 1909 LAW. It has been held by a Federal District Court that a corporation stockholder is not taxable under the 1909 Law on stock dividends received.[1]

[1] U. S. v. Philadelphia B. & W. R. Co., 262 Fed. 188.

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INCOME DERIVED ON SALE OF STOCK RECEIVED AS DIVIDEND. Stock received as a dividend does not constitute taxable income to the stockholder, but any profit derived by the stockholder from the sale of such stock is taxable income to him. For the purpose of ascertaining the gain or loss derived from the sale of such stock, or from the sale of the stock with respect to which it is issued, the cost (used to include also, where required, the fair market value as of March 1, 1913) of both the old and new shares is to be determined in accordance with the following rules:

(1) Where the stock issued as a dividend is all of substantially the same character or preference as the stock upon which the stock dividends is paid, the cost of each share of both the old and new stock will be the quotient of the cost, or fair market value as of March 1, 1913, if acquired prior to that date, of the old shares of stock divided by the total number of the old and new shares.

(2) Where the stock issued as a dividend is in whole or in part of a character or preference materially different from the stock upon which the stock dividend is paid, the cost, or fair market value as of March 1, 1913, if acquired prior to that date, of the old shares of stock shall be divided between such old stock and the new stock, or classes of new stock, in proportion, as nearly as may be, to the respective values of each

class of stock, old and new, at the time the new shares of stock are issued, and the cost of each share of stock will be the quotient of the cost of the class to which such share belongs divided by the number of shares in that class.

(3) Where the stock with respect to which a stock dividend is issued was purchased at different times and at different prices and the identity of the lots can not be determined, any sale of the original stock will be charged to the earliest purchases of such stock, and any sale of dividend stock issued with respect to such stock will be presumed to have been made from the stock issued with respect to the earliest purchased stock, to the amount of the dividend chargeable to such stock.[1]

[1] T. D. 3059, Treasury Bulletin 35-20-1161, revoking Reg. 45, Arts. 1545, 1546 and 1642, and amending Art. 1547; O. D. 732, Treasury Bulletin 47-20-1308.

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Footnote 78.

Add:—S. 1081, Treasury Bulletin 11-19-368; A. R. R. 6, Treasury Bulletin 30-19-634.

CHAPTER 20.

RECEIPTS AND INCOME FROM MISCELLANEOUS SOURCES

[Page 319.]

Damages in Personal Actions. Damages in the form of yearly payments throughout the life of the injured party, recovered through the compromise of a threatened suit for breach of promise of marriage, are not regarded as a return of capital since the benefits of which the injured party was deprived were merely anticipatory. Such payments are within the statutory definition of income and are taxable to the recipient.[1] The alienation of a wife's affections is not such a personal injury as to entitle the recipient of damages therefor to exemption as to such damages. However, so far as such damages represent compensation for sickness resulting from the alienation, they are exempt.[2] Money recovered as damages in libel proceedings is subject to tax.[3]

[1] O. D. 501, Treasury Bulletin 20-20-931.

[2] S. 1384, Treasury Bulletin 24-20-997. Though the alienation of a wife's affections is a personal injury (Leicester v. Hoadley, 66 Kans. 113, 71 Pac. 318; Tinker v. Colwell, 193 U. S. 473, 487) the term "personal injuries" in Section 213 (b) 6 is held to mean physical injuries only.

[3] S. 957, Treasury Bulletin 1-19-21.

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Allocation of Income from Judgments. Where a company in 1912 entered into an agreement to sell oil to another company, at 90 cents per barrel, delivery to extend over two years, the latter company to have an option to extend the term of the contract and to pay for oil thereafter delivered at a price equal to the highest contract price then being paid by any one of four of the largest purchasing companies, and did exercise such option and dispute arose as to the price to be paid, the buying company paying only 50 cents a barrel and the selling company claiming $1.00 a barrel, the price being finally fixed

by the courts in 1912 at $1.00 and the buying company ordered to pay the balance of 50 cents a barrel, it has been held that such balance is income to the buying company for the year in which received and not for the year or years in which the right of action accrued.[1]

[1] Sol. Op. 41, Treasury Bulletin 34-20-1159; see Jackson v. Smietanka, Dist. Ct., N. Dist. Ill., E. Div.; T. D. 2960.

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Labor Union Benefits. Benefits paid by a labor union to members during a strike constitute taxable income.[1]

[1] O D. 552, Treasury Bulletin 25-20-1011.

[Page 320.]

Payment of Claims. In the case of an estate which on March 1, 1913, owned a claim against some individual or business or Government organization, the difference between the amount received in payment of the claim and the actual value of the claim March 1, 1913, is either gain or loss, as the case may be, to be reported in the return for the year in which the claim was settled. Interest accrued on the claim from March 1, 1913, to date of settlement is taxable income to the estate. If payment was received in securities which can be proved to have been worth less than face value, the amount to be reported as taxable income is reduced accordingly. If the securities are sold, taxable income will be realized or a deductible loss sustained to the extent of the difference between the amount received from the sale and the actual value of the securities at the time acquired.[1]

[1] O. D. 6, Treasury Bulletin 1-19-11.

[Page 320.]

Compensation for Loss. The rulings discussed in this and the following paragraphs of the 1920 edition are applicable to property used for residential or farming purposes.[1] Where a taxpayer elects to replace a vessel by one somewhat larger, so long as the general type of the boat is the same as the boat

[1] O. D. 513, Treasury Bulletin 21-20-513.

lost or destroyed, it may fairly be taken as a replacement in kind, in so far as it equals the tonnage of the original vessel. There should be charged against the replacement fund only such portion of the cost of the new vessel as would represent the cost of a boat of the carrying capacity of the old vessel, with allowance for depreciation.[2] Where the Government having requisitioned vessels from a taxpayer for use in the war, returns the same vessels in an unfit condition for their former use, giving the taxpayer a sum of money in lieu of restoration, the vessels are deemed to be substantially different property from that taken from the taxpayer, and the taxpayer may elect to sell the vessels returned and place the proceeds, together with the money paid in lieu of restoration, in a replacement fund.[3] Where the owner of a requisitioned tug uses the proceeds to buy barges, he does not replace in kind within the meaning of the above rulings.[4] The period during which the replacement fund may be maintained may properly be limited to one year with the privilege of the taxpayer to apply at the end thereof for a further extension of time.[5]

[2] T. B. M. 61, Treasury Bulletin 15-19-443.
[3] T. B. R. 41, Treasury Bulletin 12-19-400.
[4] O. 914, Treasury Bulletin 20-19-504.
[5] T. B. M. 61, Treasury Bulletin 15-19-443.

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Footnote 11.

The latest ruling of the Treasury Department is that where business property was destroyed by fire and the taxpayer immediately replaced such property with property of substantially the same kind, the excess of the cost of replacement over the amount of insurance received as compensation for the property destroyed can not be taken as a loss. It is treated as a capital expenditure, which is recoverable through depreciation deductions. (O. D. 697, Treasury Bulletin 43-20-1258.)

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Pensions. Pensions paid by governments or by private employers to persons by whom services have been rendered are in the nature of additional compensation for such services and are consequently distinguishable from gifts, properly so called. When one enters the service of an employer who has

inaugurated a pension system, such system is one of the inducements for entering the employment, and in such circumstances the fact that the pension is part of the compensation received, and not a gift, is very clear. Even when the pension is granted after the employment has been commenced and without any compulsion, legal or moral, of the employer, it may still fairly be regarded as additional compensation. When the pensions are awarded by one to whom no services have been rendered and who has received no direct benefit from the services rendered, it seems impossible to regard them as additional compensation. There is no essential difference in the payments to teachers and the widows of teachers by the Carnegie Foundation for the advancement of teaching from those made to indigent persons by ordinary charitable societies, and they are therefore mere gifts or gratuities. The fact that they take the form of pensions and are within the dictionary definition of the term "pension" does not take them out of the definition of the term "gift." The term "pension" and "gift" are not mutually exclusive. The same payments may be both pensions and gifts.[1]

[1] O. 1040, Treasury Bulletin 28-20-1051 overruling Treasury Bulletin 2-20-670. See In re Strong, 1 Tax Cas. 207; Blakeston v. Cooper, 5 Tax Cas. 347; Turner v. Cuxson, 2 Tax Cas. 422; Turton v. Cooper, 5 Tax Cas. 148.

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Proceeds of Life Insurance. Amounts received by an individual beneficiary or by the estate of the insured under the terms of an ordinary life, continuous installment bond contract issued by a life insurance company are exempt. This applies not only to the installment payments received but also to any dividends received under the terms of the bond.[1]

Where under a life insurance policy there is payable to a first beneficiary named 6 per cent. per annum of the face value of the policy during life, and, upon the death of the first beneficiary, the face value of the policy is payable to a second beneficiary, the payments to the first beneficiary are a part of

[1] O. D. 433, Treasury Bulletin 14-20-825.

the proceeds of the policy, and are not to be included in gross income for the purpose of the income tax.[2]

When a taxpayer takes out an insurance policy on the tontine plan in 1902 and in 1917 receives the total accumulated dividends, the face value of the policy being payable to assured in 1922, if living, the amount received in 1917 is not income for that year. The excess of the amount received at maturity of the policy plus all dividends received thereon, over the total premiums paid prior to March 1, 1913, or the cash surrender value of the policy as of that date, whichever is greater, plus the premiums paid subsequent to March 1, 1913, will represent taxable income to be reported for the year in which received.[3]

[2] O. 995, Treasury Bulletin 10-20-778.

[3] O. D. 490, Treasury Bulletin 19-20-910.

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Property Acquired by Gift. Where an executor receives a bequest conditioned upon his continuous performance of duties as executor, such a bequest will be deemed compensation for his services, although it is expressly additional to the executor's legal commissions.[1]

The following opinion has been issued in definition of gifts:

(a) Where it appears that the owner of property has purported to transfer it without consideration to a member of his own family, or to any other person with whom he is in confidential relations, and that shortly thereafter a profitable sale of the security or property so transferred has occurred, such facts constitute prima facie evidence that the purported gift was not an actual gift and that the transfer was, in fact, merely colorable. In such case the so-called gift should be ignored in calculating tax, and the case should be investigated

[1] O. 980, Treasury Bulletin 4-20-700. This ruling is based upon the theory that the bequest is, in effect. additional compensation for services as executor. The Revenue Act of 1918 taxes compensation for personal services "in whatever form paid" (Revenue Act of 1918, Sec. 213). Notwithstanding this comprehensive clause, the ruling seems a doubtful interpretation of a statute which expressly exempts bequests. (See Bullen v. Wisconsin, 240 U. S. 625.)

for evidence on which a charge of fraud could be supported in a contest.

(b) The prima facie case made out by the facts mentioned in the preceding paragraph may be rebutted by proof which establishes that it was not a transaction primarily for the advantage of the donor, and that there was no agreement or understanding, tacit or otherwise, that the donor was to receive back the proceeds or at any time control their disposition. Mere statements by the parties to the effect that the gift was genuine are regarded as of little weight; the best proof that a gift was a real gift would consist of facts showing that the position or relationship of the parties is such as to show a reasonable occasion for such a gift being made, and such as to explain the sale by the donee. Inquiry should be made as to the disposition of the proceeds.

(c) Where a taxpayer purports to make a gift to a member of his family or to a person in a confidential relation to himself, but no sale occurs, the question whether such gift was real or merely colorable is one to be decided on all of the facts. The mere fact that such conveyance is made may not lawfully be regarded as proof of fraud; but if the effect of the gift is to diminish tax liability, and it appears, either at the time of the gift or at any time thereafter, that the donor is deriving advantage from the property which he purported to give away, such facts constitute prima facie evidence that the gift was only colorable and the transaction should be treated as a nullity unless other facts are developed which show that it was a true gift. If such a gift is colorable only and made for the purpose of escaping tax, the donor is guilty of fraud and subject to penalty and punishment therefor.[2]

An owner of nontax-free Liberty bonds who has made an absolute gift of the coupons attached to the bonds covering interest due for a number of years will be required to include in his income tax return the interest which accrues each year on the bonds, and to pay any tax that may be due thereon.[3]

[2] S. 1022, Treasury Bulletin 7-19-290.

[3] O. D. 120, Treasury Bulletin 3-19-181.

a purchaser of bonds. The purchase price of the bond even though different from par represents the investment. When the bonds mature or are sold the basis for determining the gain or loss is their purchase price or their fair market value as at March 1, 1913, if acquired prior to that date.[1]

[1] O. D. 475, Treasury Bulletin 17-20-887.

CHAPTER 23.

DEDUCTION OF INTEREST

[Page 358.]

Footnote 6.

Add:—O. D. 40, Treasury Bulletin 1-19-57.

[Page 359.]

Interest Paid or Accrued Within the Year. Where a lumber company entered into a contract for the purchase of a timber tract, agreeing to pay for the quantity of timber which it is estimated will be cut each year, payment to be made at the time each block is cut at a certain rate per thousand feet, plus interest at 6 per cent. per annum from the date of contract, it has been held that inasmuch as the interest charge did not accrue and become payable until the timber was cut, it was not a proper deduction until that time. The agreement is an executory contract to purchase the timber and no interest is deductible except as the contract is executed. The interest payment does not constitute an operating expense of the company, but enters into the cost of the lumber produced that year.[1]

[1] O. D. 595, Treasury Bulletin 29-20-1075.

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Sale and Retirement of Corporate Bonds. A corporation which issued its bonds at a discount and improperly charged the discount to profit and loss may correct its books to show the discount treated as interest paid in advance, to be amortized over the life of the bonds. Amended returns reflecting correction in the books may be filed.[1] Amortization of premiums or discount on bonds is not permissible in the case of a purchaser of bonds. The purchase price of the bond even though different from par represents the investment. When

[1] O. D. 111, Treasury Bulletin 2-19-166.

the bonds mature or are sold the basis for determining the gain or loss is their purchase price or their fair market value as at March 1, 1913, if acquired prior to that date.[2]

[2] O. D. 475, Treasury Bulletin 17-20-887.

[Page 361.]

Interest on Overdue Federal Income and Excess-Profits Taxes. Interest paid or accrued on overdue Federal income and excess-profits taxes is held not to be a part of the tax but is deductible as interest.[1]

[1] This applies to all interest added to the tax under the provisions of Sec. 250 of the Revenue Act of 1918. O. 922, Treasury Bulletin 7-20-745; O. D. 319, Treasury Bulletin 26-19-595.

CHAPTER 24.

DEDUCTION OF TAXES

[Page 363.]

Taxes Paid or Accrued Within the Year. The New York State franchise tax imposed for the privilege of doing business in that State for the fiscal year of the State ending October 31, 1920, is based on 1918 income, but is not due and payable until a later date. A taxpayer making a calendar year return on an accrual basis may deduct two-twelfths of such tax in his return for 1919 and ten-twelfths in his return for 1920.[1] Munitions taxes are properly chargeable against the income of the year in which the munitions are made and sold or otherwise disposed of. When the books of the manufacturer are kept upon an accrual basis the amount of such taxes should be included as a deduction from income, and the liability therefor should appear upon the books of account of the company at the close of the taxable year.[2] It has been ruled that a corporation might not accrue munitions taxes for 1916 and 1917 and deduct as expenses the amount so accrued during each year in its munitions tax return for that year before the final computation of the munitions tax had been made. The munitions tax as finally computed must be deducted in the income tax return for the year in which the tax is accrued, irrespective of the year in which the tax is actually paid.[3] Taxpayers must use either the accrual method or the receipts and disbursements method consistently. A corporation making a return for a fiscal year ending during the calendar year 1917, but prior to October 3, was not entitled to deduct from gross income both the Federal income tax *paid* prior to January 1,

[1] O. D. 371, Treasury Bulletin 3-20-687. See also O. D. 388, Treasury Bulletin 5-20-715.

[2] A. R. M. 26, Treasury Bulletin 5-20-713.

[3] A. R. M. 29, Treasury Bulletin 9-20-770. It must be assumed that the corporation involved in this ruling reports on an accrual basis.

1917, and the income tax *accrued* on its books of account during the months of the fiscal year falling within the calendar year 1916.[4]

[4] S. 1305, Treasury Bulletin 8-20-754.

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Federal Duties and Excise Taxes. An individual may claim as a deduction the amount of war tax paid on facilities furnished by public utilities, which includes the tax on railroad and steamship fares and the tax paid on admissions and dues. The war excise taxes imposed on articles sold or leased by the manufacturer, producer, or importer[1] are levied against and are paid by the manufacturer, producer or importer and are not deductible by the individual purchaser. The consumption taxes imposed by the Revenue Act of 1918[2] on semi-luxuries sold by dealers are paid by the purchaser and are deductible by him.[3]

[1] See Revenue Act of 1918, Section 900.
[2] Revenue Act of 1918, Section 904.
[3] O. D. 287, Treasury Bulletin 22-19-535.

[Page 364.]

Footnote 8.
Add:—O. D. 137, Treasury Bulletin 4-19-216.

[Page 364.]

EXCISE TAXES PAID TO CUBAN GOVERNMENT. The Republic of Cuba imposes on all corporations operating sugar plantations in Cuba a tax of a certain amount on each bag of sugar produced. This tax is based on production, not on income, and is in the nature of an excise tax. A domestic corporation may deduct from gross income in its return to the United States Government the amount of such tax paid to the Cuban Government, but may not claim the amount as a credit against the total tax due to the United States.[1]

[1] O. D. 372, Treasury Bulletin 3-20-688.

[Page 365.]

Taxes Paid by Vendee for Vendor. If, in pursuance of a contract, a vendee corporation agrees to pay the income and

excess-profits taxes, on profits arising out of the sales returned by the vendor corporation on a calendar-year basis, such vendee corporation may, if it reports on an accrual basis for a fiscal year ending in October of the calendar year, submit an amended return in which the extent of the accrual of such taxes in such fiscal year is deducted from gross income. If, however, such contracts are regularly entered into by the vendee corporation as a consistent practice, the vendee corporation should be allowed the deduction as for the year in which the taxes are paid or determined, unless gross distortion of income, as between years, results.[1]

[1] A. R. M. 16, Treasury Bulletin 2-20-669.

[Page 365.]

Taxes Not Deductible. Additions to tax because of a delinquent return may be deducted from gross income and will not be disallowed on the ground that they are part of the income or profits taxes within the provisions of law forbidding the deduction from gross income of such taxes.[1]

[1] O. 926, Treasury Bulletin 23-19-551.

[Page 365.]

Taxes Paid by Tenant. Assessments for local benefits paid by a tenant for his landlord according to agreement are held to be additional rent paid by the tenant, and therefore deductible from his gross income. The amount so received by the landlord is taxable income to him, but because of its nature is not an allowable deduction from his gross income.[1]

[1] O. D. 373, Treasury Bulletin 3-20-689.

[Page 365.]

Footnote 17.

Add:—O. D. 41, Treasury Bulletin 1-19-58.

[Page 366.]

TAXES ASSESSED AGAINST LOCAL BENEFITS. Taxpayers will be required to show, in their income tax returns, the nature of assessments paid under the Illinois drainage laws, inasmuch as such laws provide both for special assessments

for benefits and for general taxation, depending in some instances upon ordinances promulgated by the trustees of drainage districts.[1]

[1] O. 928, Treasury Bulletin 24-19-561.

[Page 367.]

STATE INHERITANCE TAXES. Interest upon an overdue Federal estate tax is not deductible.[1]

[1] O. D. 594, Treasury Bulletin 29-20-1074.

[Page 368.]

Footnote 25.

Prentiss v. Eisner, 260 Fed. 589, affirmed 267 Fed. 16. See also Op. A. G. 1, Treasury Bulletin 16-20-875; O. 812, Treasury Bulletin 13-19-419.

[Page 368.]

Footnote 4.

Eliot Nat. Bank v. Gill, 210 Fed. 933.

[Page 368.]

TAXES PAID BY CORPORATION FOR STOCKHOLDERS. Trust companies, building and loan associations and savings banks organized under the laws of Oregon are not allowed to deduct from gross income taxes paid upon the value of their shares of stock.[1] It has also been held that State banks, savings banks, and trust companies located in South Dakota may not deduct from gross income taxes paid upon the value of their outstanding shares of capital stock, since such tax is primarily the obligation of the holders of the stock.[2]

It is stated in the 1920 edition that taxes paid to a State by various corporations upon shares of their stock owned by another corporation are not deductible from gross income of the latter corporation as taxes "paid by it," such taxes not being paid by this corporation, but in its behalf, by other corporations.[3] The practice of the Treasury Department in this

[1] O. D. 70, Treasury Bulletin 1-19-99.

[2] A. R. M. 88, Treasury Bulletin 44-20-1281.

[3] This statement is based upon the case of U. S. v. Aetna Life Ins. Co., 260 Fed. 333, and the case so holds under the 1909 Law.

regard is, however, to allow the deduction of such taxes by the corporation in whose behalf they are paid. Under the Revenue Act of 1918, amounts received by stockholders of a corporation as dividends from another corporation taxable upon its net income are also allowable deductions.[4] The proper procedure of the corporation in whose behalf the taxes are so paid would seem, therefore, to be to include the taxes in its gross income, to deduct them from gross income as dividends received, and to deduct them as taxes paid.[5]

[4] Revenue Act of 1918, Section 234 (a) 6.

[5] O. 858, Treasury Bulletin 7-19-302; O. D. 199, Treasury Bulletin 9-19-344.

CHAPTER 25.

DEDUCTION OF LOSSES

[Page 371.]

Footnote 4.

Losses sustained by a corporation in *ultra vires* transactions are not deductible (O. 968, Treasury Bulletin 1-20-660).

[Page 372.]

PROPERTY ACQUIRED BY GIFT. A loss sustained from the sale of property acquired by gift, bequest, devise, or descent (whenever property so acquired is as a matter of fact acquired for purposes of profit) is a deductible loss from gross income. Ordinary investment property so acquired is to be treated as having been acquired for purposes of profit unless the conduct of the recipient furnishes evidence to the contrary.[1]

[1] T. B. R. 35, Treasury Bulletin 10-19-357.

[Page 372.]

Losses Not Sustained in Trade. The provision permitting the deduction of losses incurred "in any transaction entered into for profit" does not contemplate that a distinction shall be made between an investment in property or securities with the object of deriving an income from the capital employed, and an investment which is made for the purpose of realizing a profit on the resale of the property or securities purchased.[1]

Where a person purchases bonds for another, guaranteeing said bonds against any loss, and a loss occurs due to subsequent insolvency of the corporation issuing same, and the guarantor makes good the loss, the same is not deductible unless such loss occurs in trade or business or in a transaction entered into for profit.[2]

Where a taxpayer sells his residence at a loss because of the

[1] O. D. 138, Treasury Bulletin 4-19-218.

[2] O. D. 241, Treasury Bulletin 13-19-420.

acceptance of a business proposition necessitating his removal to another part of the country, the loss is not a loss "incurred in his business or trade" within the meaning of the Revenue Act of 1916, as amended.[3] A loss sustained by an individual from the sale of residential property is held to be deductible under the Revenue Act of 1918 if the property was purchased or constructed by him with a view to its subsequent sale for pecuniary profit. The intent in purchasing or constructing the property is a question of fact determinable in each case by evidence which should be submitted with the return. If the residential property be held by the purchaser out of use or under tenancy and be subsequently sold, there would seem little room for question that the transaction was "entered into for profit" and that the loss, if any, is a proper deduction in determining net income. If, on the other hand, the property is occupied by the purchaser as his home during the whole or a great portion of the period of his ownership, a strong presumption is raised that the property was purchased for his personal use as a residence; that the transaction was not "entered into for profit" within the meaning of the statute. This presumption will not be overcome by his self-serving declaration, uncorroborated, that his purpose was otherwise.

An individual claiming deduction for loss incurred in the sale of residential property should attach to his return an affidavit stating the facts as to the purpose and use of the property in connection with which loss is claimed and his intent in purchasing it, and his affidavit should be supported by other evidence showing his intent when he entered into the transaction.[4]

The subletting of an apartment by a tenant on account of being required to make his residence in another city, is held not to be a "transaction entered into for profit." Therefore,

[3] A. R. R. 96, Treasury Bulletin 19-20-918. The ruling of the Treasury Department is similar under the 1918 Law. (Reg. 45, Art. 141; T. D. 2972.) See the comment in footnote 10, page 372 of 1920 edition.

[4] O. 780, Treasury Bulletin 1-19-51; A. R. R. 249, Treasury Bulletin 35-20-1168.

any loss sustained through such transaction is not deductible from gross income.[5]

Where borrowed money is stolen from the borrower and the amount has been borrowed for use in a business deal, the borrower may deduct the amount borrowed with interest paid thereon as a loss, but any amounts expended in apprehending the thief are regarded as a personal expense.[6]

Where a person gives property away or is divested thereof by death, no realization of loss results therefrom.[7]

[5] O. D. 42, Treasury Bulletin 1-19-59.

[6] O. D. 571, Treasury Bulletin 27-20-1040.

[7] T. D. 2972, amending Reg. 45, Art. 141.

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Footnote 13.

In Mente v. Eisner, 266 Fed. 161, arising under the 1913 Law, the majority opinion approved the Treasury Department's rather narrow construction of the word "trade". In this case the plaintiff whose regular business was *manufacturing* jute bags and bagging, cotton bags, etc., suffered losses in dealing in futures on the Cotton Exchange and was not permitted to deduct such losses on the theory that they were isolated transactions outside the regular business of the taxpayer. Manton, J., dissents in a long opinion on the general ground that the statute contained no distinction between a regular dealer on the Exchange and a person who dealt casually on the Exchange; that though the principal business of plaintiff was bagging, his transactions on the Cotton Exchange were nevertheless "in trade." The plaintiff in this case does not appear to have spent so much time in the Cotton Exchange transactions as did the plaintiff in the Bryce Case (Bryce v. Keith, 257 Fed. 133) in the transactions involved in that case. See also A. R. R. 242, Treasury Bulletin 33-20-1131, and A. R. R. 249, Treasury Bulletin 35-20-1168.

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Losses Must Be Sustained During Year. If a mother is *bona fide* indebted to her son and discharges the obligation by transferring stock to him, any excess of the market value of such stock on March 1, 1913, or its cost if acquired subsequently thereto, over the amount of the debt and unpaid interest is a deductible loss. This payment of a valid indebtedness is equivalent to a sale in constituting a closed and com-

pleted transaction.[1] Under New York State laws, a safe-deposit company is required to wait two years before opening any safe-deposit box for nonpayment of rent. The fact that no rental is paid during these years and it is impossible of collection does not permit the company to take a deduction from gross income in an amount equal to the rental value of any deposit box which it by law is prevented from opening, unless the company's books are kept on an accrual basis and such amount has actually been accrued. That a taxpayer might derive greater profits if it were not for restrictions placed upon his activities by Federal or State laws has no bearing on his returns for Federal income tax purposes.[2]

[1] O. D. 555, Treasury Bulletin 25-20-1015.
[2] O. D. 486, Treasury Bulletin 18-20-899.

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SALE OF STOCK OR SECURITIES. If a taxpayer makes an actual *bona fide* sale of securities at a loss in 1918, the loss is deductible even though the taxpayer repurchases the securities in the succeeding year at the same price for which they were sold. However, the burden of proof will be on the taxpayer to show that the sale was not fictitious.[1]

[1] O. D. 373, Treasury Bulletin 3-20-689.

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Footnote 21.
Add.—T. D. 2972.

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Losses Arising from Theft. A loss incurred by a corporation through the embezzlement of its funds is an allowable deduction from gross income for the year in which the embezzlement occurs; the time of the discovery of the loss bears no relation to the date it was sustained.[1] A loss incurred by a corporation through the embezzlement of securities held in bailment by it is an allowable deduction from gross income of the year in which demand was made by the bailors for the

[1] O. 845, Treasury Bulletin 6-19-275. See paragraph "Recoveries on Losses" of this supplement referring to page 388 of the 1920 edition.

return of the securities and the replacement made by the company.[2]

[2] A. R. R. 269, Treasury Bulletin 40-20-1221. In this case at the time of the embezzlement the amount of the loss to the company could not be determined, for it was controlled by the replacement cost of the securities at the date of demand by the owners. The claims against the company might have been waived by the clients and in that case the company would have sustained no loss. Furthermore. the liability of the company to the clients on account of the loss of the property held in bailment was not certain and might have been contested, the company contending that in a bailment for mutual benefit it is held to the exercise of ordinary care in relation to the subject matter thereof and is responsible only for ordinary negligence. (New York Cent. R. Co. v. Lockwood, 17 Wall. 357; Bleakley v. New York, 39 Fed. 807; Fairmont Coal Co. v. Jones, etc., Co. 134 Fed. 711; Smith v. British Steamship Co., 123 Fed. 76.) The amount expended by the company was in fact a payment in settlement of a legal liability. The right of action of the clients accrued when the demand was made for the return of the securities. and the liability of the company was incurred on that date. (Stevens v. Stevens, 132 Mo. App. 624; Walker v. Bement, 94 N. E. 339; Woods v. Latta, 3 Mont. 9; Brown v. Cook, 9 John. 361.)

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Loss by Destruction or Disappearance of Property. It is held that a loss sustained by reason of the damage of a pleasure automobile due to an accident attributable to the icy condition of the streets is not deductible as a loss sustained "by other casualty."[1]

[1] O. D. 629, Treasury Bulletin 33-20-1132. This ruling seems a questionable interpretation of the statute. The statute provides for a deduction of losses not connected with the trade or business "if arising from fires, storms, shipwreck, or other casualty or from theft, * * *." It would seem that the words "other casualty" are broad enough to include a loss due to icy condition of streets. The word "casualty" has been defined by the courts as follows: "An accident or casualty, according to common understanding, proceeds from an unknown cause or is an unusual effect of a known cause. Either may be properly said to occur by chance and unexpectedly." (Chicago. St. Louis, etc., R. Co. v. Pullman Co., 139 U. S. 79.) The only justification for the ruling is the limitation of the word "casualty" by reference to the words immediately preceding it (see U. S. v. 1150½ Lbs. of Celluloid, 82 Fed. 627) but this is not a cast iron rule and has been disregarded in the construction of the clause "all other gains and profits derived from any source whatever" contained in the Virginia Income Tax Law (see Com-

monwealth v. Werth, 116 Va. 604, 82 S. E. 695; see page 222, 1920 edition). This clause is very similar to the omnibus clause used in section 213 (a) of the Revenue Act of 1918.

Where a ring is lost and the owner is in doubt as to whether it was stolen, the loss is not deductible as a loss sustained "by other casualty." This term is held to embrace losses arising through the action of natural physical forces and which occur suddenly, unexpectedly, and without design of the one suffering the loss. Of course if the owner of the ring can establish the fact that it was stolen, the loss will be one arising from "theft."[2]

A taxpayer's personal residence located on a beach was damaged by a storm, which washed away part of the foundation and so undermined the building as to render its destruction certain if it was not immediately removed. In removing the building to a safer location it was further damaged. The damage caused by the direct action of the storm and by the removal to avoid further probable damage is held to have arisen from storm and deductible from gross income as a loss. If the building was moved to prevent further loss from the storm in question, the expense of moving it is also deductible as a loss; but if it was moved to prevent probable losses from future storms, the expense of moving it is regarded as a capital expenditure and should be added to the cost of the building in computing profit in the event of its sale, since the removal to a safer locality presumably increased its value.[3]

[2] O. D. 526, Treasury Bulletin 22-20-969.
[3] O. D. 698, Treasury Bulletin 43-20-1259.

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Shrinkage in Securities and Stocks. A taxpayer who, prior to March 1, 1913, purchased bonds which had a market value as of March 1, 1913, above par, and which were redeemed at par in 1919, is entitled to deduct, as a loss in 1919, the difference between the market value on March 1, 1913, and the value received in 1919 upon maturity of the bonds.[1] It has

[1] O. D. 506, Treasury Bulletin 20-20-937.

been held in a recent case[2] under the 1909 Law that an insurance company, the greater portion of whose assets consist of stocks, bonds, and other securities, is entitled to deduct the amount of the market depreciation of such securities during the year. The court said in part: "It is here admitted that, judged by any standard familiar to business men, the securities of plaintiff were worth at the end of 1910 several million dollars less than they were at the beginning of that year. It is further admitted that, not only was it the business custom of plaintiff to revalue its securities in accordance with the market annually, but that such procedure was and is a reasonable business conservatism, and a frequent, though not universal, statutory requirement. Under this taxing act the question is not strictly whether depreciation in market value is a loss, but whether, when Congress specifically includes within 'losses actually sustained within the year, * * * a reasonable allowance for depreciation of property,' depreciation does not become a loss, no matter what persons other than Congress may think on the subject. We have no doubt that this loss in market value is depreciation. The word means, by derivation and common usage, a 'fall in value; reduction of worth'; and it seems to us to require mention only to prove that the average citizen, for whom statutes are assumed to be made, would judge depreciation of his own bonds by the opinion of the public, however thoroughly convinced of the ultimate wisdom of holding onto what had depreciated. * * * The plain inference is that the phrase is used in the statute in a sense that would be generally understood in business circles, and we hold that the depreciation claimed by plaintiff in its return is used in that sense, and should have been allowed as a deduction."

[2] New York Life Ins. Co. v. Anderson, 263 Fed. 527, reversing 257 Fed. 576. The soundness of this view may be doubted. (See Fink v. Northwestern Mutual Life Ins. Co., U. S. Circuit Ct. of Appeals, Seventh Circuit, June, 1920, T. D. 3057, Treasury Bulletin 36-20-1187. See the limiting definition of depreciation in Von Baumbach v. Sargent Land Co., 242 U. S. 534.

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Footnote 40.

Add:—T. D. 2882, Treasury Bulletin 9-19-341.

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TRANSFER OF SECURITIES AT DEPRECIATED VALUE TO CORPORATION FORMED FOR THE PURPOSE. In a case arising under the 1917 Law, the stockholders of an industrial company owning certain stocks and bonds carried as liquid reserves for opportune purchases of material, established a new corporation having the same stockholders with the same proportionate stock holdings. The new company then bought the above stocks and bonds at market prices which were substantially lower than the cost or market value as of March 1, 1913, of the securities to the old company. A small amount of cash received from the sale of its capital stock was given by the new company in payment for the securities and the balance of the purchase price was given in demand notes bearing 6% interest with the same securities as collateral. The possession of the securities was retained by the old corporation with a power of sale in case of default in payment of the notes. The new corporation had no other assets. The Treasury Department held the whole transaction to be a sham and a subterfuge to evade taxation with the result that no loss could be deducted under the alleged sale of the securities by the old corporation. This decision was based upon the following grounds: (1) that the identity of stock ownership of the two corporations being similar they would be deemed affiliated with the result that intercorporate transactions would be eliminated, (2) that by reason of the identity of stock ownership the old corporation continued in practical control of the new corporation, the form of disposition having no other purpose than to postpone the realization of gain or loss on the securities and the retention of control not only postponing realization by preserving the power of the old corporation to undo the entire transaction and revest itself with the securities without violating any substantial rights or interests. In other words, the transaction did not indicate a *bona fide* change in legal relations made by

the taxpayer to reduce taxes but accomplished no actual or substantial change in conditions, the loss apparently realized being a mere bookkeeping transaction.[1]

[1] L. O. 1035 (Rev.). Treasury Bulletin 40-20-1222. Upon the point that taxing authorities are not bound to recognize the form adopted by the taxpayer to evade the imposition of taxes where such forms do not reflect an actual change in circumstances (Loud Co. v. Elmer Township, 123 Mich. 61, 81 N. W. 965; Montgomery v. Marshall Co. (Iowa), 129 N. W. 329; Sisler v. Foster, 72 Ohio 437, 74 N. E. 639; Shotwell v. Moore, 129 U. S. 590.

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Voluntary Payment by Stockholders of Loss of Corporation. The surrender of stock for the purpose of wiping out an operating deficit can not be made the basis of a deduction in the returns of the individual stockholders.[1]

[1] O. D. 216, Treasury Bulletin 11-19-378.

[Page 383.]

Losses of Oil and Gas. If a taxpayer purchases royalty interests in tracts of oil land (not including title to the land itself) and such interests prove worthless, as evidenced by all wells drilled proving dry or failing after producing very small quantities of oil, the loss sustained is an allowable deduction from gross income.[1]

[1] O. D. 375, Treasury Bulletin 3-20-691.

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Reserves for Losses. Amounts set aside by canners of perishable food products as a reserve against which to charge losses due to climatic and other natural conditions producing shortage of the raw products, are not deductible in computing net income.[1]

[1] T. B. R. 13, Treasury Bulletin 3-19-187.

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Reserves for Cash Discounts. A corporation keeping its accounts on an accrual basis will not be permitted to deduct from gross income a sum in anticipation of the amount the

corporation may be required to allow as cash discount on accounts due and payable in the succeeding year. But any amounts so allowed in the succeeding year before the return is filed may be deducted from gross sales for the previous taxable year.[1]

[1] O. D. 146, Treasury Bulletin 4-19-228.

[Page 383.]

Worthless Debts. A transaction in which the majority stockholder of a corporation, to whom the corporation was heavily indebted, agreed to take as payment the free assets of the company and to assume its liabilities other than its bonded indebtedness is considered a cancellation of the debt and any loss sustained by the majority stockholder is deductible only in the return for the year when the transaction took place, and not when the assets were disposed of subsequently. The measure of the loss would be the difference between the liabilities assumed, including the debt to the majority stockholder, and the value of the assets at the time received by him.[1]

[1] A. R. R. 30, Treasury Bulletin 9-20-772.

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MUST BE CHARGED OFF ON BOOKS. In 1919, a corporation purchased notes from a merchant and advanced sums of money to him on bills of sale. In January, 1920, it developed that the notes were forged and the bills of sale were fraudulent. The losses were charged off the books on March 12, 1920. It was held that the losses are deductible as bad debts rather than other losses in the taxable year 1920, when they were ascertained to be worthless and charged off, regardless of when they actually became worthless.[1]

[1] O. D. 604, Treasury Bulletin 30-20-1090.

[Page 385.]

WHEN DEBTS MAY BE CONSIDERED WORTHLESS. Bank deposits in Russian banks can not be considered as worthless for the purpose of claiming a deductible loss in a return for

the taxable year 1919. Russian rubles in the form of bank deposits were sold during the latter months of 1919, which would indicate that they were not at that time worthless.[1] Where, however, a taxpayer purchased credits on Russian banks and it appeared that all efforts to communicate with the Russian banks had proved futile, the New York bank from which the credits were purchased having been informed by the State Department that there were no postal facilities with Petrograd, and the New York bank's Swedish correspondent having been unable to communicate with the Russian banks and information from other sources indicating that the assets of the Russian banks had been taken over and dissipated by the Russian Soviet Republic, other information indicating that the banks had been looted by the Revolutionists, the amounts paid for the credits were permitted to be deducted as a worthless debt in 1918. Even though a stable Russian government should fulfill international obligations and restore the ruble to a normal parity of exchange, such action would not necessarily affect the Russian banks against which the credits were issued.[2]

Debts due by one belligerent State to the citizens of another State are not extinguishable by war. Consequently, a taxpayer having an outstanding claim against the German Government, dating before the war, would not be justified in charging the amount of the claim as a loss when war was declared between the United States and the German Government.[3]

[1] O. D. 535, Treasury Bulletin 23-20-986.
[2] A. R. M. 64, Treasury Bulletin 27-20-1041.
[3] A. R. M. 31, Treasury Bulletin 9-20-771.

[Page 385.]
Footnote 57.
O. D. 297, Treasury Bulletin 24-19-564.

[Page 386.]
FORECLOSURE OF MORTGAGES. A mortgage is a security for a debt or obligation and an incident thereto; a debt or obliga-

tion of some kind is an essential element of a mortgage.[1] A second mortgage is a mortgage without intervening liens between it and the first mortgage.[2] A creditor whose debt is secured by a mortgage has two remedies—one *in personam* for his debt, and the other *in rem* to subject the mortgaged property to its payment.[3] Where a mortgage is given to secure the payment of a debt, the creditor may pursue his remedy either on the mortgage or on the evidence of the debt, or on both concurrently.[4] Where the proceeds of a foreclosure sale are not sufficient to satisfy the mortgage debt, the mortgagee may thereafter maintain an action at law against the person liable for such deficiency.[5] Since the mortgagee may maintain an action against the mortgagor for the amount of the debt, it is not sufficient, in order to deduct the amount as a bad debt, that he show only a failure of the security, as the mortgagor may be solvent and the debt collectible; but he also must show that legal action against the mortgagor resulted in no recovery, or that such action would in all probability not result in the satisfaction of execution on a judgment. If the debt existed prior to March 1, 1913, only its value on that date may be deducted upon subsequently ascertaining it to be worthless.[6]

[1] Carrol v. Tomlinson, 192 Ill. 398, 61 N. E. 484.
[2] Appeal of Green, 97 Pa. 342.
[3] Silvey v. Axley, 118 N. C. 959, 23 S. E. 933.
[4] Ober v. Gallagher, 93 U. S. 199.
[5] Shepherd v. May, 115 U. S. 505.
[6] O. D. 687, Treasury Bulletin 42-20-1244.

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Recoveries on Losses. All the statutory provisions regarding the deduction of losses limit the deductible losses to those "not compensated for by insurance or otherwise".[1] Where a loss occurs in one taxable period, and compensation therefor, or recovery thereon, in whole or in part, occurs in a subsequent taxable period the question arises whether the amount of the compensation or recovery is taxable as income in the year received or is to be applied in reduction of the original loss

[1] Revenue Act of 1918, Sec. 234 (a), 214 (a) 4, 5, 6.

through the medium of amended returns. The rulings on this point are indicated in the following paragraphs.

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EMBEZZLEMENTS RECOVERED. A loss incurred by a corporation through embezzlement is an allowable deduction from gross income for the year in which the embezzlement occurred. Where the embezzlement is not discovered in the taxable year but is later discovered and admitted by the embezzler, a part of the money being promptly recovered, the amount so recovered tends to diminish the amount of allowable deductions on account of the embezzlement for the year in which the embezzlement occurred, and is ordinarily not returnable as income in the year when received.[1] If fidelity insurance is recovered, it should be treated as indicated in the next paragraph.

[1] O. 845, Treasury Bulletin 6-19-279, modifying Solicitor's memorandum 698; U. S. v. Cleveland, Cinn., Chicago & St. Louis Ry. Co., U. S. Dist. Ct., So. Dist. Ohio, February 23, 1916 (not reported in the Federal Reporter). In the last mentioned case, prior to 1909 covering a period of several years, the treasurer of the defendant railway company had embezzled a large sum of money, but the embezzlement was not discovered until the year 1909. The defendant claimed a deduction of this amount from its gross income under the Act of August 5, 1909, which, like the present statute, limited the deductions on account of losses to those "actually sustained during the year." The court said: "The time of the discovery of a loss bears no relation to the date the loss was sustained. The loss was sustained when the theft occurred, although the defendant did not know at the time of the depletion of its assets. As each embezzlement occurred, the defendant was poorer to the extent of it. It then sustained a loss. One of the definitions of 'sustained' is 'undergo'. As each embezzlement occurred, the defendant underwent the loss of that much money. It is clear that the defendant is not entitled to the deduction claimed."

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INSURANCE RECEIVED IN SUBSEQUENT YEAR. Where embezzlement by a bonded employee occurs, there is no loss as to the amount of insurance recoverable even though it is not

received in the same taxable period. The claim against the bonding company is considered the equivalent of cash.[1]

When an insured loss occurs in one taxable year and the insurance is not recovered during that year the taxpayer should compute his loss by deducting from the total loss the estimated amount of the recoverable insurance. The loss so determined should be deducted from the taxpayer's gross income of the year in which the loss was sustained. If subsequent events demonstrate that this estimate was substantially incorrect, an amended return should be filed correcting the mistake.[2]

[1] O. 845, Treasury Bulletin 6-19-279; O. D. 165, Treasury Bulletin 6-19-273.

[2] T. B. R. 55, Treasury Bulletin 18-19-482.

[Page 388.]

Net Losses. A net operating business loss in 1919 occasioned by floods is a net loss.[1] A 1918 loss due to the failure and liquidation of two corporations in which an individual owns stock is not a net loss, but is merely a loss on securities.[2]

An individual who sustained a net loss for a taxable year beginning after October 31, 1918, and ending prior to January 1, 1920, with respect to his share of partnership earnings is not entitled to the relief provided by the net loss provision of the Revenue Act of 1918 unless he has sustained a net loss for such taxable year with respect to his entire income derived from all sources duirng that year.[3] A corporation whose taxable year is not included in the period between October 31, 1918, and January 1, 1920, is not entitled to the relief afforded by the net loss provision. Consequently a corporation doing business on a fiscal-year basis may not allocate its net loss and deduct the amount apportioned to that part of its fiscal year falling within the period October 31, 1918, to January 1, 1920.[4]

If a taxpayer changes his accounting period in such manner

[1] O. D. 367, Treasury Bulletin 3-20-681.

[2] O. D. 380, Treasury Bulletin 4-20-703.

[3] O. D. 430, Treasury Bulletin 14-20-822.

[4] O. D. 511, Treasury Bulletin 21-20-947.

that the period from the close of his previous taxable year to the close of his newly established taxable year *falls between* October 31, 1918, and January 1, 1920, and he sustains a net loss during such fractional year period, he is not entitled to the relief provided by the net loss provision of the Revenue Act of 1918, since the net loss sustained is not for a full taxable year as provided by the Act.[5] A company which earned a large income during the fiscal year ending September 30, 1918, and which suffered a net loss during the year ending September 30, 1919, will not be permitted to change its accounting period for 1918 to the calendar year basis so as to be allowed to deduct the above net loss from taxable income for the calendar year 1918. The accounting period ending September 30, 1918, for which the large tax liability had accrued and the method of accounting employed during that period were accomplished facts which could not be changed by the Commissioner.[6]

[5] O. D. 445, Treasury Bulletin 15-20-841.

[6] T. D. 3044, Treasury Bulletin 30-20-1087.

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ALLOWANCE OF NET LOSS. If a taxpayer suffers a net loss for any taxable year beginning after October 31, 1918, and ending prior to January 1, 1920, and *had no net income* for the preceding taxable year, the entire amount of the loss is deductible in computing net income for the succeeding taxable year.[1]

[1] O. D. 431, Treasury Bulletin 14-20-823.

[Page 389.]

Losses in Inventory and From Rebates. In a case in which a corporation, engaged in manufacturing patent flours, sold during 1918 large quantities of flour manufactured from substitutes in accordance with regulations issued by the Food Administration and abolished upon the cessation of hostilities, which flour the corporation took back in the first six months of 1919 and resold, the Treasury Department has held that the difference between the amount of returned flour and the amount thereof resold and the inventory thereof re-

maining cannot be deducted as a loss in inventory or from rebates. It did not appear in this case whether there was an actual loss sustained by this taxpayer through the resale of these goods below cost of manufacture, or whether the so-called "loss" was merely a reduction in the amount of profit that would have been made if the goods had not been taken back from the jobbing houses; but this had no material effect upon the case. Whether or not the taxpayer accepted the return of such goods in 1919 appears to have been a matter entirely at its own option and if, as a matter of business prudence and expediency, it decided so to do, the resulting loss, if any, was due to its own act and by its own election in 1919, and was held not to be such a loss as can be properly charged, under the law, against the profits of the year 1918.[1] A company which earned a large income during the fiscal year ending September 30, 1918, and which suffered a net loss during the year ending September 30, 1919, because of certain non-cancellable contracts for the future delivery of materials which were not completed for delivery prior to the termination of the fiscal year ending September 30, 1918, the value of this material having been greatly decreased as a result of the signing of the armistice on November 11, 1918, has been held not to be entitled to a deduction for inventory loss. The company did not own the material on September 30, 1918, but had only a contract for its purchase. Such material was not properly included in its inventory for such taxable period nor was the amount due under the contract for the material entered on the books during such period as a liability. In other words, the loss suffered was not a loss "resulting from any material reduction * * * of the value of the inventory *for such taxable year*." The phrase "substantial loss of the character above described" does not enlarge the definition of inventory losses contained in the earlier part of the subdivision of the statute authorizing the deduction of such losses.[2]

[1] A. R. R. 155, Treasury Bulletin 26-20-1028.
[2] T. D. 3044, Treasury Bulletin 30-20-1087.

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LOSS IN INVENTORY. In fixing the cost of the manufactured articles inventoried, all of the costs of manufacture applicable to the particular article may be taken into consideration, but no claim will be allowed for speculative or anticipated profits. No claim should be made for the loss of an anticipated profit on labor or material used in producing the articles.[1]

An inventory loss can not be proven by evidence showing that a loss has been sustained in respect of a part of the inventory, without showing that the amount of the loss for which the claim has been filed has not been offset by profits made on the remainder of the inventory. The term "temporary fluctuation," means a fluctuation in prices, which does not develop into a steady settled market.[2]

Goods ordered in 1918 and delivered in 1919, where title has not passed until subsequent to the close of the taxable year 1918, can not be included in the 1918 inventory, and any loss realized upon such transactions are losses of the taxable year 1919.[3] An established loss through reduction after the close of the taxable year 1918 in the value of liquor inventoried at the close of that year and remaining unsold at the close of the taxable year 1919 constitutes an allowable deduction. The lack of market for and lack of market value of the liquor must be established.[4] In the case of a taxpayer making a return for a fiscal year beginning in 1917 and ending in 1918, the provisions relating to loss in inventory, apply to the computation of the tax under the Revenue Act of 1916 and the Revenue Act of 1917 at the 1917 rates, as well as to the computation under the 1918 Act at the 1918 rates.[5]

Shrinkage in inventory values sustained during 1919 by a partnership business which prior to November 4, 1918, was operated as a corporation may not be taken as a deduction from the net income of the corporation for the taxable year

[1] O. D. 47, Treasury Bulletin 1-19-64.

[2] T. B. M. 52, Treasury Bulletin 12-19-52; A. R. R. 291, Treasury Bulletin 43-20-1260.

[3] T. B. R. 15, Treasury Bulletin 5-19-251.

[4] O. D. 390, Treasury Bulletin 5-20-717.

[5] T. B. R. 10, Treasury Bulletin 3-19-193.

1918, even though the individual partners were stockholders of the former corporation.[6]

[6] O. D. 263, Treasury Bulletin 17-19-471.

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LOSS FROM REBATES. Rebates actually paid after the close of the taxable year, other than those paid in pursuance of contracts entered into during such year upon sales made during such year, are not allowable deductions.[1] Rebates made during 1919 on account of defective goods purchased in 1918 are not of the class referred to in this provision of the statute and can not, therefore, be included in a claim for abatement or refund filed under such provisions.[2]

[1] A. R. M. 4, Treasury Bulletin 28-19-614.
[2] O. D. 382, Treasury Bulletin 4-20-705.

[Page 398.]

CLAIMS OF PARTNERSHIPS. Each partner will be required to furnish a separate bond in the requisite amount.[1]

[1] O. D. 218, Treasury Bulletin 11-19-380.

[Page 398.]

Footnote 81.
Add:—O. D. 186, Treasury Bulletin 8-19-323.

[Page 399.]

LIBERTY OR OTHER BONDS AS SECURITY. Where Liberty bonds are deposited as collateral, as provided when a claim for abatement for a loss in inventory is filed, coupons representing one year's interest may be detached from the bonds prior to depositing them as collateral on Form 1124.[1]

[1] O. D. 193, Treasury Bulletin 8-19-336.

CHAPTER 26.

DEDUCTION OF ALLOWANCE FOR DEPRECIATION, OBSOLESCENCE AND AMORTIZATION

[Page 402.]

Depreciable Property. A member of a local draft board who used his automobile for travel on business in connection with the work of the board may not deduct any amount representing wear and tear of the automobile or maintenance expense, the automobile being used for his personal convenience and not by reason of official necessity since such members when traveling under competent orders were allowed actual traveling expenses plus a *per diem* of $4.[1]

[1] O. D. 363, Treasury Bulletin 2-20-673.

[Page 404.]

LEASES. In the case of a lease held by the original lessee, who acquired it prior to March 1, 1913, without any payment other than a stipulated annual rent, the presumption is that the lease had no value as at March 1, 1913. Under this presumption there is no basis for a depreciation deduction. This presumption can be overcome only by evidence showing conclusively that the lease had a value as of March 1, 1913, for depreciation purposes. There is no prescribed method by which the value of a lease as of March 1, 1913, in excess of its presumptive value as at that date may be established. The burden is upon the taxpayer to establish the basis for depreciation to the satisfaction of the Commissioner.[1]

[1] O. D. 720, Treasury Bulletin 45-20-1292.

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Intangible Property. A deduction for depreciation may be taken on all intangible property, including patents and copyrights, the use of which in the trade or business is definitely limited in duration, whether such intangibles were acquired

for cash, other property or corporate stock. The term "capital outlay" includes corporate stock.[1]

[1] O. D. 344, Treasury Bulletin 30-19-640.

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Footnote 23.

Add:—A. R. M. 95, Treasury Bulletin 47-20-1312; T. B. R. 59. Treasury Bulletin 20-19-506.

[Page 405.]

DEPRECIATION ALLOWANCE FOR PATENT OR COPYRIGHT. Where an individual has invented certain apparatus and, after securing United States patents thereon, assigned such patents to a foreign corporation under an agreement by which he retained 40% interest in profits therefrom, legal title to the patents passing to the corporation subject to the agreement mentioned and his interest being recognized by the corporation and by the United States licensees under the patents, the Department has held that the agreement should be recognized as giving the individual a depreciable interest in the patents. The value of each patent as at March 1, 1913, should be segregated and the depreciation allowable thereon determined on the basis of its own life instead of using as a basis the average life of all the patents and the value of all the patents in bulk. Of the total depreciation allowable for any year, 60% is deductible in the return of the company and 40% in the individual's return.[1]

The following schedule of the terms of patents and trademarks in various countries has been published by the Treasury Department for the information of taxpayers.:[2]

Country.	Term of patent.	Term of trade-mark.
Great Britain...	16 years. Extended from 14 years by act of Parliament, 1919.	14 years renewable.
France	5, 10, or 15 years from filing of application......	15 years renewable.
Germany	15 years from next day after filing..............	10 years renewable.
Russia	15 years	1 to 10.
Canada	18 years	General unlimited; special 25 years renewable.
Australia	14 years	14 years renewable.
Austria	15 years	10 years renewable.
Switzerland	10 years for chemical process. 15 years from filing	20 years renewable.
Sweden	15 years from filing	10 years renewable.
Denmark	15 years	10 years renewable.
United States...	17 years	20 years renewable.

[1] A. R. M. 35, Treasury Bulletin 10-20-779.

[2] O. D. 721, Treasury Bulletin 45-20-1293.

The duration of patent rights in Great Britain was extended from

14 to 16 years in 1919 (see 9, and 9 and 10, Geo. V, c. 80, Chitty. Annual Statutes 1919, p. 423). No corresponding change seems to have been made with respect to trade-marks. Important patent legislation is now pending in France which will radically change the existing law if passed. The only actual change in duration of patents and trade-marks since 1909 in the countries named seems to have been in Great Britain as indicated above.

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DEPRECIATION OF DRAWINGS AND MODELS. Where no appraisal has been made on or about March 1, 1913, the value of drawings, models, tracings and patterns as of that date may be ascertained by taking the reproduction cost on March 1, 1913, determined from data in the possession of the taxpayer less depreciation from original acquisition.[1]

[1] A. R. R. 272, Treasury Bulletin 40-20-1223.

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Capital Sum Returnable Through Depreciation Allowances. The replacement value of property can not be substituted for the cost of the property as the cost of replacement at a time some years in the future is a speculative figure which can not be used as a basis for determining an annual depreciation charge. The depreciation charge will replace the amount of the original capital outlay, which may be more or less than adequate to replace the item to which it applies. If less than adequate, new capital must be provided from surplus or otherwise to effect the replacement.[1] Where the lessee of real property erects buildings, or makes permanent improvements which become part of the realty and income or loss has been returned by the lessor as a result thereof, the capital sum to be replaced by depreciation allowances is held to be the same as though no such buildings had been erected or such improvements made.[2] Where a corporation was liquidated and its assets transferred to a partnership organized by its stockholders, the allowance for depreciation will be based on the cost of the property to the partners. The fair market value of the

[1] O. D. 283. Treasury Bulletin 21-19-524.

[2] Reg. 45, Art. 164, as amended by T. D. 3062, Treasury Bulletin 37-20-1198.

assets as of the date of liquidation of the corporation will be held to be the cost of the assets to the stockholders, who as partners, turned them over to the partnership. Such fair market value as of the date of liquidation divided by the estimated life of the assets from that date will constitute the annual depreciation allowance of the partnership.[3]

[3] O. D. 639, Treasury Bulletin 34-20-1148.

[Page 407.]

Method of Computing Depreciation Allowance. Inasmuch as under the provisions of the Income Tax Acts in effect prior to the Revenue Act of 1918 deductions for obsolescence of property were not allowed except as a loss for the year in which the property was sold or permanently abandoned, a taxpayer may for 1918 and subsequent years revise the estimate of the useful life of any property so as to allow for such future obsolescence as may be expected from experience to result from the normal progress of the art.[1]

[1] Reg. 45, Art. 166, as amended by T. D. 3061, Treasury Bulletin 37-20-1192.

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Footnote 32.

Add:—An interesting question is presented as to when depreciation may first be taken in the case, for instance, of a plant the construction of which extends over a long period of time. It seems clear that depreciation may be taken on any units of the plant from the moment they are put in use.

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DEPRECIATION OF STEAMERS. Three per cent. has been held to be a reasonable allowance for depreciation of bulk freight steamships on the Great Lakes; however, when due to peculiar conditions, it can be definitely determined that the established rate of depreciation will not be sufficient to return all of the capital invested, as at the date of acquisition or March 1, 1913, whichever is later, by the time the vessel will be rendered useless, an addition to the regular rate to cover obsolescence may be allowed. The amount of this addition must be determined upon the basis of the facts in each

particular case—that is, the type of the vessel in question, the fitness for possible use in other lines of transportation, and the date when it can be definitely foreseen that she will be no longer commercially useful in this particular line of traffic. This rule does not necessarily apply to steamers engaged in other lines of traffic, for the reason that there are distinct differences in the method of construction and the matter of operation of package freighters and passenger steamers and the bulk freighters under consideration.[1] The Department has held that the proper annual rate of depreciation on steam schooners engaged in the coastwise lumber trade is 5%, based upon an expected life of 20 years.[2]

[1] A. R. R. 27, Treasury Bulletin 9-20-773.
[2] A. R. R. 279, Treasury Bulletin 42-20-1245.

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EXTRAORDINARY DEPRECIATION. When delicate machinery designed for the manufacture of a certain product is used in manufacturing a product of much coarser materials for which use it is not fitted, and is operated at a heavy overload of its normal capacity, the owner is entitled to deduct from gross income an amount representing extraordinary depreciation.[1]

[1] A. R. R. 45, Treasury Bulletin 16-20-862.

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Closing Depreciation Account as to Any Item. Where a taxpayer engaged in distilling has claimed a deduction for loss in 1917 due to the abandonment of the business through operation of law, part of such loss being disallowed by the Department but a subsequent sale in 1918 conclusively establishing the reasonableness of the deduction, it has been ruled that the taxpayer may be allowed to deduct for 1917 the amount claimed, his 1918 deduction being correspondingly reduced.[1]

[1] A. R. R. 93, Treasury Bulletin 19-20-919.

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Obsolescence. No amount may be charged off in any year in anticipation of obsolescence of a building which *may* become

obsolete 5 or 10 years later. However, a certain amount of obsolescence may be claimed from the time that it becomes certain that at a definite future date the building will be obsolete. The figure representing obsolescence should be, approximately, the difference between the fair market value of the building as of March 1, 1913, or its cost if acquired after that date, less depreciation, and the estimated salvage value. This obsolescence should be spread over the period from the time such obsolescence becomes certain until the building becomes obsolete and should be claimed in those years. For instance, the fair market value of a building March 1, 1913, was $30,000. Its depreciated value December 31, 1918, was represented by $18,000, and its estimated salvage value will be $5,000 in 1920. At that time (December 31, 1918) it was definitely determined and certain that in 1920 the building would have to be torn down and rebuilt, due to its inadequacy to meet the growing needs of the industry it housed. The difference between the depreciated value December 31, 1918, namely, $18,000, and its estimated salvage value of $5,000, represents obsolescence. This amount of $13,000 should be spread over the years covering the period 1919 and 1920 and deductions claimed accordingly for those years. In cases where oblescence is claimed it must be supported by facts which will enable the Commissioner to determine whether such claim is proper and allowable.[1] An inventor of a war device, which undoubtedly had a large value on January 1, 1918, when the war was on in full force, has been held not entitled to claim a deduction for depreciation and obsolescence based on the value of the intangible property as of that date and on December 31, 1918, after the signing of the armistice, when it is claimed it had a very small value.[2]

[1] O. D. 381, Treasury Bulletin 4-20-704.

[2] T. B. M. 39, Treasury Bulletin 7-19-291. It is not clear whether obsolescence was disallowed in this case on the ground that the cost of the patents, or their fair market value on March 1, 1913, did not exceed their value at the end of 1918, their value having merely appreciated during the war, or on the ground that the ending of the war failed definitely to prove their obsolescence. It would seem that obsolescence of patents should be allowed in many cases as a result of the end-

ing of the war if it can be definitely shown that as a result thereof substantial contracts were cancelled or the patents otherwise lost their value in whole or in part at the time of the armistice. In other words, while the ending of the war might not *per se* constitute sufficiently tangible proof of the obsolescence, there might well be accompanying circumstances which would prove obsolescence beyond any doubt.

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Obsolescence of Intangible Property. Obsolescence is not ordinarily applicable in the case of intangibles but will be allowed in exceptional cases, as in the case of the discontinuance of a going business because of the exhaustion of its source of supply, where the cost of the good will, or its value as of March 1, 1913, if acquired prior to that date, can be definitely shown and the period of its obsolescence determined with reasonable accuracy. To sustain a claim for deduction for obsolescence of good will, it must be shown that the good will will be of no value at the close of an approximately definite period, and that the taxpayer will be forced to discontinue the business and be unable to continue in any similar business. An allowance for obsolescence of good will will be made only in connection with such good will as is assignable, as distinguished from good will attaching to individuals owning or conducting a business, or to the premises at which it is or was conducted; and no allowance for obsolescence will be granted in any case where, in connection with the operation of the business, the good will will be valuable in another business after the termination of the business in which the taxpayer is engaged. A corporation engaged in the business of sampling ores is entitled to a deduction for obsolescence not only of its plant and equipment but for value of good will existing and having a definitely established value as of March 1, 1913, or acquired thereafter by capital outlay, if it can be shown that the plant and equipment will be useless and the good will of no value at the close of an approximately definite period by reason of exhaustion of the ores on which its business depends.[1]

[1] O. D. 472, Treasury Bulletin 17-20-884.

[Page 415.]

Obsolescence in the Case of Distillers, Dealers in Liquor, Etc. An allowance for obsolescence of intangible assets (trade-marks, trade brands, etc.) of a corporation engaged in the wholesale and retail liquor business will not be permitted in 1917 if the corporation had a considerable volume of sales in 1918 showing that the intangible assets had some value on December 31, 1917, even though they may have shrunk considerably in value by that date.[1] Deductions from gross income on account of depreciation or obsolescence of intangibles, such as good will, trade-marks, and trade brands, allowed distillers and dealers in liquors, are also applicable to brewers.[2] Property consisting of a plant, including equipment for the manufacture of beer bottles, which because of restrictions and regulations by the United States Government on the brewery industry can not be sold and in consequence the factory had to be closed, has, to the extent the property or plant was constructed for the manufacture of beer bottles and is not suited or adapted for any other purpose without reconstruction, become obsolete. The corporation to that extent is entitled to a deduction for obsolescence. So much of the shrinkage in value of the plant, if any, as is not thus due to obsolescence can not be claimed as a deduction for loss until the property is sold or becomes worthless and the loss is definitely ascertained.[3]

[1] A. R. R. 185, Treasury Bulletin 29-20-1076.
[2] O. D. 298, Treasury Bulletin 24-19-565.
[3] O. D. 125, Treasury Bulletin 3-19-190.

[Page 418.]

Footnote 56.
Add:—T. B. R. 44, Treasury Bulletin 15-19-445.

[Page 418.]

Obsolescence of Vineyards. Where vineyards planted to wine grapes appear to be rendered useless for profitable operation as vineyards through the enactment of prohibition legislation, but the owners continue to cultivate them in the hope that some new and profitable use for the crop may be found, a reasonable deduction for obsolescence may be claimed. There

being at this time no data available upon which a determination of what constitutes a reasonable deduction may be made, a tentative deduction of one-half the loss which would result from the total abandonment of the property for vineyard purposes may be made in the return for the year in which the legislation was enacted, subject to adjustment when the success or failure of the experiment shall have been satisfactorily established. Where vineyards devoted to the growing of wine grapes are, as a result of prohibition legislation, abandoned as vineyards and the vines and improvements incidental solely to grape growing are junked and the land employed in other uses, the loss directly resulting may be deducted in determining the net income of the owner, care being taken to exclude from the deduction the value of any improvements, such as installation of drainage or irrigation, fencing, breaking up of the soil, and similar improvements which, while incidental to the plantng of the vineyard, tend to permanently improve the ground for other uses. The allowance for obsolescence will be distributed over the period elapsing between the passage of the prohibition measure and the date when abandonment occurs. In general, no deduction for obsolescence or obsoleteness is allowable in the case of land, but in exceptional cases, where the loss of usefulness through prohibition legislation is so great that the land practically becomes worthless, the taxpayer may, upon proper showing, be allowed a reasonable deduction on that account for the land as well as for the vines and improvements. In this case the cost or value used as the basis of such deduction for obsolescence or obsoleteness may properly include the value of any improvements which when made were regarded as permanently improving the land and which have not heretofore been charged off as expenses. In the case where the entire deduction is claimed in a single year by reason of actual abandonment on account of obsolescence of land, vines, and improvements, the amount of such deduction will be the difference between the value on March 1, 1913, if acquired prior to that date, or the cost, if acquired on or after that date, and the salvage or junk value, taking into account any deductions or obsolescence previously

allowed. Where a reasonable allowance for obsolescence is claimed before actual abandonment, to be spread over a period of two or more years, care must be taken to eliminate from the sum used as the basis of the allowance any general decrease in the value of real estate due to other causes, such decrease being deductible only when definitely determined through sale. Any return of income from vineyard property in which a deduction is claimed as a result of obsolescence must be accompanied with an affidavit setting forth fully the facts necessary to a determination of the loss properly chargeable to obsolescence under the rules above stated.[1]

[1] O. 862, Treasury Bulletin 8-19-320, modifying O. D. 102, Treasury Bulletin 2-19-150, and superseding T. B. M. 18, Treasury Bulletin 4-19-219.

[Page 419.]

Footnote 58.

Add:—The Committee on Appeals and Review is of the opinion that Congress in using the phrase "at any time within three years after the termination of the present war" intended to place a limitation only upon the latest date before which the contemplated redetermination must be made and that it was not the purpose of Congress to place a limitation upon the *earliest* date at which such redetermination might be undertaken. Taxpayers, therefore, need not await the formal termination of the war, but may present to the Commissioner their claim for a redetermination at any time prior to three years after such termination. (A. R. M. 10, Treasury Bulletin 31-19-646.)

[Page 420.]

PROPERTY THE COST OF WHICH MAY BE AMORTIZED. Machinery, equipment or other facilities erected or acquired on or after April 6, 1917, for the production or manufacture of sugar are considered as contributing to the prosecution of the war and the cost may, therefore, be amortized.[1]

[1] O. D. 259, Treasury Bulletin 16-19-464.

[Page 421.]

COST WHICH MAY BE AMORTIZED. For the purpose of making returns in 1919 the total amount to be extinguished by amortization is the difference between the value of the prop-

erty on the bases indicated below and the original cost of the property less any amounts otherwise deducted for depreciation, losses, etc., prior to January 1, 1918; or in the case of property acquired or completed after December 31, 1917, it is the difference between the value of the property on the bases indicated below and the cost of such property at the date of acquisition or completion. (1) In the case of property useful only during the war period and permanently discarded at the date of the return the basis is the salvage value as of the date when the property was discarded. (2) In the case of property still in use which will not be required for the future use of the business and which is certain to be permanently discarded before the last installment payment of the tax covered by the return the basis is the salvage value as of the date when the property will be permanently discarded. (3) In the case of other property the basis for amortization calculation will be the estimated value of the property to the taxpayer in terms of its actual use or employment in his going business, such value in no case to be less than the sale or salvage value of the property, provided, however, that in no case may the preliminary estimate (for purposes of returns to be made in 1919) of the amount of such amortization exceed 25% of the cost of property. In the final determination the amount of the amortization allowance will be ascertained upon the basis of stable post war conditions under regulations to be promulgated when these conditions become apparent. A special record of all property falling in classes (1) and (2) must be preserved by the taxpayer and the Commissioner must be promptly advised (a) if such property is restored to use; (b) the selling price if sold; and (c), if still on hand and not in use at the close of the three-year period, the reasons why such property has not been disposed of.[1] In any case where a taxpayer has deducted on account of amortization an amount in excess of the preliminary estimate of 25% of the cost of property and it is found upon consideration that he is entitled to an amount exceeding 25% of the cost of the property, but less than the amount originally deducted, the 5 per cent. pen-

[1] Reg. 45, Art. 184, as amended by Treasury Decision 2859.

alty and 1 per cent. interest on account of negligence has been held additional tax due on account of amortization claimed but disallowed in the return for 1918. In the event that the case is reopened within a period of three years and an additional amount of amortization allowed, the penalty and interest will not attach to the amount of tax based on the additional allowance granted. In other words, penalty and interest should attach only to such amount of tax as, upon final settlement, is found to have been due to the Government and not paid at the time of filing return by reason of the taxpayer's disregard of the regulations.[2]

[2] A. R. M. 24, Treasury Bulletin 3-20-692.

CHAPTER 27.

DEPLETION—IN GENERAL

[Page 427.]

Depletion of Mines, Oil and Gas Wells. The deduction for depletion in the case of mines, oil and gas wells, as the result of discovery on or after March 1, 1913, is allowed only to the party in possession at the time of discovery, and not to subsequent purchasers.[1]

[1] T. D. 3089, Treasury Bulletin 47-20-1313.

[Page 428.]

Footnote 7.

Add.—The depletion which has or should have been taken must be based upon the same cost or fair market value and is subtracted whether or not it (or any part thereof) has been allowed under earlier laws. (T. B. R. 4, Treasury Bulletin 1-19-53.)

[Page 429.]

Apportionment of Deductions Between Lessor and Lessee. The depletion value which may be set up in the case of the discovery of mines, oil and gas wells as the result of a discovery on or after March 1, 1913, is in the case of a lease, to be equitably apportioned between the lessor and lessee.[1]

[1] T. D. 3089, Treasury Bulletin 47-20-1313.

[Page 433.]

Rule Under the 1913 Law. The term "gross value at the mine" means in the case of a coal mine the market value of the prepared coal at the mine where said value is established by actual sales at the mine; and where the market value is established at some place other than the mine the gross value at the mine means the price for which the coal is sold less transportation charges.[1]

[1] S. 1365, Treasury Bulletin 18-20-900.

[Page 434.]

Rule as to Mine Under the 1916 Law. In a case arising under the 1916 Law the price at which property was offered for sale on May 1, 1914, has been accepted as the fair market value of mining property on March 1, 1913, in the absence of evidence showing a change in value between these two dates.[1]

[1] S. 1365, Treasury Bulletin 18-20-900.

[Page 435.]

Rule as to Lessees Under Prior Laws. In the 1920 edition it was stated that under the Acts of 1909, 1913, and 1916, the lessee under a mining lease was not permitted an allowance for depletion, but was permitted to deduct royalties paid pursuant to such a lease, including any lump sum paid in advance for the lease, such lump sum being deductible on the theory that it constituted rent paid in advance and being allocable to the several years on a per unit basis. The lessee might also deduct cost of development not deducted as expense, such cost being also allocable on a per unit basis. In a footnote to this paragraph a case arising under the 1916 law was referred to, in which the District Court held that the 1916 law permitted the deduction by a lessee of an allowance for depletion.[1] Since the publication of that edition, this case has been reversed by the Circuit Court of Appeals,[2] and the United States Supreme Court has recently denied an application for a writ of certiorari.[3] It appears that the Mohawk Mining Company on February 7, 1905, acquired a mining lease upon a tract of land in Minnesota, paying $81,250 therefor and agreeing to pay a royalty of $0.25 per ton as the ore was mined and removed from the premises. Immediately thereafter the mining company entered into possession of the leased property and opened

[1] Mohawk Mining Co. v. Weiss, U. S. Dist. Ct., No. D. of Ohio, I. T. S. 1919, paragraph 3635.

[2] The case was submitted to the Circuit Court of Appeals on February 9, 1920, and was decided on March 2, 1920. The opinion was corrected and refiled on June 15, 1920. The Court rendered a further opinion on June 15, 1920, on a petition for a rehearing. (See 264 Fed. 502.)

[3] The application for a writ of certiorari was number 475 on the October Term of the United States Supreme Court.

a mine, spending a large sum of money in sinking shafts, driving entries, etc. On March 1, 1913, there were 1,106,389 tons of ore in the mine, of an agreed value of $0.49875 per ton, considering the entire deposit *en bloc*. The value of the lease on March 1, 1913, was $275,214.26. The term was sufficient to enable the lessee to mine out all the ore. In its 1916 and 1917 returns the mining company deducted allowances for depletion—$46,096.61 in 1916 and $66,467 in 1917, such depletion being at the rate of $0.24875 per ton on the ore removed in such years. Of these amounts the Commissioner allowed a deduction in 1916 and 1917 at the rate of $0.04 per ton on the ore removed in such years, it being agreed that such amount, when applied to all the ore known to be in the mine in 1905, would free from tax the $81,250 originally paid for the lease by the mining company. The disallowance of any further depletion was based solely on the ground that the mining company was not the owner of the ore or mine content, but was only the lessee or contractor.[4] In reversing the decision of the

[4] The Court said: "We cannot conceive any substantial distinction as applied to a mine between that depreciation *or allowance for capital assets consumed* which was sought by mine owners under the earlier acts, and that depletion which was expressly allowed by the amendment of 1916. From every point of view, this kind of depreciation *or allowance* was depletion and this allowed depletion is depreciation *or diminution of capital* and when the question or right to the allowance arises as between fee owner and lessee, it can make no difference whether the claimed allowance is called by one name or by the other. In U. S. v. Biwabik Co., 247 U. S. 116 (arising under the Act of 1909), it was ruled, after full consideration, that under a lease, practically identical with the Mohawk lease now involved, the nature of the interest held by the lessee was not such as to permit it to claim the allowance, but that the contingencies which attended the character of the lessee's interest barred it from claiming that its capital assets had been diminished. It is true that the question whether the mining of ore could be considered depreciation in any event was underlying, and that this question has been completely removed by the amendment of 1916, but the Supreme Court did not rest its conclusion at all upon the definition of depreciation." (Original opinion as revised.) "In the Biwabik case, the lessee was not heard to say that his capital assets had been consumed by his mining operations, and we interpret that decision as resting in an essential degree on the idea that the nature of the lessee's title forbade him to make this claim. We can not read the decisions of the supreme court

as having determined that the exhaustion of ore reserves is so inherently a business loss rather than an impairment of capital, that a statutory grant of the right to deduct for depletion on that account will reach a case which has been adjudged not to involve the diminution of capital assets. We think the substantial principles established by the decisions are that both the royalty received by the fee owner and the sums received by the operating lessee above the cost of operation are income; that the statutory reduction for 'depletion' cannot be twice credited. once to the fee owner and once to the lessee; and that the exemption belongs of right to the fee owner." (On petition for rehearing.) In the case under consideration this gives the fee owner a depletion allowance of $.49875 per ton although his royalty under the contract is only $.25 per ton. The contention of the lessee, however, was not that each should claim an allowance of $.49875 per ton but that such aggregate value per ton on the deposit *en bloc* should be shared by lessor and lessee.

District Court permitting an allowance for depletion and reversing the Commissioner, the Circuit Court of Appeals relied almost entirely upon a decision of the United States Supreme Court under the 1909 law.[5] In this case the defendant acquired a leasehold in certain ore producing properties in Minnesota from which it mined ore from that date to and including the year 1910. This lease was acquired by payment to the prior lessee of the sum of $612,000 in addition to contracting to pay a royalty of $0.30 per ton upon ore mined. In its 1910 return the defendant deducted the sum of $265,372.08 "to cover realization of unearned increment." The amount of this deduction was arrived at by multiplying the number of tons of ore mined during the year by $0.4875, which was the market value of the ore in place on January 1, 1909. The District Court held that the deduction could not be allowed since the lease was not a conveyance of the ore in place, but was merely a grant of the privilege of entering upon the premises and mining and removing the ore. This Court allowed, however, the deduction of the sum of $0.03885 per ton, which represented an allowance of part of the cost of $612,000 calculated upon a per unit basis. This decision of the District Court was reversed by the Circuit Court of Appeals.[6] The Supreme Court, however, repudiating the construction of its

[5] U. S. v. Biwabik Mining Co., 247 U. S. 116.

[6] Biwabik Mining Co. v. U. S., 242 Fed. 9.

earlier opinions placed upon such opinions by the Circuit Court of Appeals, held that the defendant was not entitled to the depletion claimed. The Supreme Court did not pass upon the propriety of the deduction of $.03885 per ton allowed by the District Court as the Government had taken no writ of error as to this partial deduction. This decision of the United States Supreme Court must be considered in the light of the prior decisions of the Supreme Court upon the question of depletion under the 1909 law[7] and also in the light of other contemporary decisions holding that in determining net income under the 1909 Law arising from the conversion of the capital assets of a taxpayer acquired before January 1, 1909, there might be deducted from the gross proceeds of the conversion an amount sufficient to restore the capital value existing on December 31, 1908.[8] The essential substance of the first of the decisions on depletion[9] was that (1) the proceeds of ores mined by a corporation from its own premises constitute income under the 1909 Law, and (2) a corporation is not entitled under that law to deduct the value of such ore in place before it is mined, from such income. The former of these two conclusions was based upon the consideration that the 1909 Law was not an *income* tax law, but imposed an excise tax on corporations engaged in business measured by net income as defined in the Act. The Mining Company, being within the taxing clause and not within the exempting clause, was taxable upon net income as defined in the Act. Thus, it seems, the income used as a measure of the 1909 tax, according to the Supreme Court, need not necessarily be true net income and may include amounts which, properly speaking, are return of capital, in a business that theoretically or practically

[7] Stratton's Independence v. Howbert, 231 U. S. 399; Von Baumbach v. Sargent Land Co., 242 U. S. 503. The decision in Goldfield Consolidated Mines v. Scott, 247 U. S. 126, was made on the same day as the Biwabik decision and reiterates the force and effect of the other cases cited adding nothing material to the discussion of the principles involved.

[8] Doyle v. Mitchell Bros., 247 U. S. 179; Hays v. Gauley Mountain Coal Co., 247 U. S. 189; Lynch v. Turrish, 247 U. S. 221; U. S. v. Cleveland, etc., Ry. Co., 247 U. S. 195.

[9] Stratton's Independence v. Howbert, 231 U. S. 399.

involves a wasting capital, especially when such income is easy of ascertainment and simply applied in practice.

In the next case[10] involving depletion the Supreme Court held that (1) so-called royalties received by the owners of lands leased for mining purposes were income within the meaning of the 1909 Law and (2) the resulting exhaustion of ore body was not an element to be considered in determining the reasonable depreciation allowed as a deduction by the 1909 Law. The former of these decisions was based upon an analysis of the mining leases involved and a citation of numerous Minnesota cases to the effect that such leases did not constitute a sale of any part of the land or ore in place. The second decision was based upon a strict interpretation of the word "depreciation", which was held not sufficiently broad to include "depletion".

Clearly, at the time the Biwabik case was decided, an owner was not entitled to any allowance for depletion under the 1909 Law, whether the mine was operated by him or he was a lessor. All the Biwabik case decided was that a lessee could not have an allowance to which a lessor was not entitled. The decision put the lessor and the lessee on an equality, and was a necessary corollary of the two prior decisions of the court. The real reason why an allowance for depletion was denied to the lessee mining company in the Biwabik case was that the statute contained no provision permitting such depletion to any one, under the head of depreciation or otherwise.

It seems that in the Mohawk Mining case the Circuit Court of Appeals misconstrued the Biwabik case. The Circuit Court of Appeals' understanding of the essence of the Biwabik decision is indicated by its statement that "the nature of the interest held by the lessee was not such as to permit it to claim the allowance" and that the "nature of the lessee's title forbade him to make this claim". This is not true. If the lessee had had the title of the lessor, he would have been entitled to no depletion. No one was entitled to depletion. The nature of a mining property, not "the nature of the lessee's title", prohibited the deduction, under the 1909 Law.

[10] Von Baumbach v. Sargent Land Co., 242 U. S. 503.

This misapprehension is probably based upon the language of the Supreme Court, reading as follows: "The lessee takes from the property the ore mined, paying for the privilege so much per ton for each ton removed. He has this right or privilege under the form of lease here involved so long as he sees fit to hold the same without exercising the privilege of cancellation herein contained. He is, as we held in the Sargent Land Co. case, in no legal sense the purchaser of the ore in place." But this language appears not to have been the basis of the decision but a mere restatement of the rule that the kind of lease involved did not constitute *pro tanto* a purchase. The statement immediately follows the criticism of the Circuit Court of Appeals' statement to this effect.

It was perhaps necessary to reiterate this point since on the same day[11] of the Biwabik decision the Supreme Court also decided other cases which held that upon the conversion of capital assets a taxpayer was entitled to deduct from the proceeds received the value of assets at the date of the incidence of the tax.[12] If the kind of lease involved had been such as to effect a sale or conversion of capital assets or ore in place, the lessor (but not the lessee) would have been entitled to what would have amounted to a depletion deduction. But this would not necessarily have helped the lessee since, even if the lease had effected a conversion of capital assets or sale of ore in place, the lessee would merely have assumed the position of an owner who had already been denied depletion. The lease would not have effected a *sale by him;* it would have meant a *purchase by him.*

The Revenue Act of 1913 and that of 1916, allow depletion.[13]

[11] May 20, 1918.

[12] Doyle v. Mitchell Bros., 247 U. S. 179; U. S. v. Cleveland, etc., Ry. Co., 247 U. S. 195; Hays v. Gauley Mountain Coal Co., 247 U. S. 189.

[13] The 1913 Law permitted the deduction of "a reasonable allowance for the exhaustion, wear and tear of property arising out of its use or employment in the business not to exceed, in the case of mines, 5 per centum of the gross value at the mine of the output for the year for which the computation is made." (Act of October 3, 1913, G (b).) The Revenue Act of 1916 provided for the deduction in the case of individuals "(a) in the case of oil and gas wells a reasonable allowance for actual reduction in flow and production to be ascertained not by the flush flow,

but by the settled production or regular flow; (b) in the case of mines a reasonable allowance for depletion thereof not to exceed the market value in the mine of the product thereof, which has been mined and sold during the year for which the return and computation are made, * * *" (Revenue Act of 1916, Sections 5, 6 and 12).

Under both statutes the Department has held that depletion is allowed only to the owner. But the lessee is allowed a deduction to provide for the amortization of his capital investment in the property, and such deduction may be measured annually in the same manner as depletion is measured—by production, or may be measured by the life of the lease. No deduction has been allowed for the value of a lease on March 1, 1913, in excess of the capital investment on that date. A very serious question arises in this connection, which the Mohawk case does not settle, namely, if the lessee had a lease on March 1, 1913, possessed of a fair market value, how is he to separate that value from his receipts in order not to be taxed on what was capital at the incidence of the tax, and on which he can not be taxed in the case of a sale under the decisions of the Supreme Court.[14]

In the case of mines the lessee has been held in the cases heard by the Supreme Court not to be the purchaser of any ore in place. Not being the purchaser, the lessee is not owner and the statute seems to limit depletion to property owned by the taxpayer. Under the theory that leases do not effect a sale of ore in place, the property of the lessee is not the ore but the contract permitting its extraction. It is intangible, not tangible property, and any allowance to the lessee must be based upon the theory that such intangible property or contract right is exhausted by its use or employment in the lessee's business or trade.

It is possible that mineral deeds or leases of land situated in States other than Minnesota may be held to constitute a sale of minerals in place, in which case a different conclusion as to the rights of lessor and lessee under the 1909 Law might follow and also a different conclusion under the 1913 and 1916 Laws as to lessees.

[14] See Doyle v. Mitchell, 247 U. S. 179; Lynch v. Turrish, 247 U. S. 221; note distinction, however, in Lynch v. Hornby, 247 U. S. 339.

The regulations issued under the 1916 law provided that "the deduction in the case of a lessee (of a mine) will be limited to an amount equal to the *capital actually invested in the lease,* without regard to value as of March 1, 1913, or any other date."[15] Under this regulation it has been held that where a corporation organized for the purpose takes over a mining lease, issuing its entire capital stock to the individual owners of the lease in proportion to their respective interests therein, the "capital actually invested in the lease" is represented by the fair market value of the stock so issued.[16]

[15] See Reg. 33, Rev. Art. 171.
[16] O. 1033, Treasury Bulletin 20-20-938.

CHAPTER 28.

DEPLETION OF MINES

[Page 439.]

Charges to Capital and to Expense in the Case of Mine. All expenditures by a mining company for prospecting and development for the purpose of enlarging the business or continuing it beyond its present limits must be charged to capital account.[1]

[1] O. D. 314, Treasury Bulletin 26-19-589.

[Page 440.]

Footnote 9.

Add:—Camp Bird Ltd. v. Howbert, 262 Fed. 114.

[Page 440.]

Accumulated Depletion. A lessor of mining property who waived his right to royalties for several years on account of the fact that the mine was operated at a loss, and received all of the royalties in the year 1917, may, if he has submitted returns for those years on a cash receipts and payments basis, deduct from the income received in 1917 such depletion allowance as appertains to that income.[1]

[1] A. R. M. 17, Treasury Bulletin 2-20-674.

CHAPTER 29.

DEPLETION OF OIL AND GAS WELLS

[Page 451.]

Computation of Allowance for Depletion of Gas Wells. On account of the peculiar conditions surrounding the production of natural gas it will be necessary to compute the depletion allowance for gas properties by methods suitable to the particular cases in question and acceptable to the Commissioner. Usually the depletion of natural gas properties should be computed on the basis of decline in closed or rock pressure, taking into account the effects of water encroachment and any other modifying factors. The gas producer will be expected to compute the depletion as accurately as possible and submit with his return a description of the method by which the computation was made. The following formula, in which the units of gas are pounds per square inch of closed pressure, is recommended: The quotient of the capital account recoverable through depletion allowances to the end of the taxable year divided by the sum of the pressures at the beginning of the year plus the sum of initial pressures of new wells and less the sum of the pressures at the time of expected abandonment (which quotient is the unit cost) multiplied by the sum of the pressures at the beginning of the taxable year plus the sum of the initial pressures of new wells and less the sum of the pressures at the end of the tax year equals the depletion allowance.[1]

[1] Reg. 45, Art. 211, as amended by T. D. 3064, Treasury Bulletin 38-20-1204.

[Page 460.]

Computation of Depletion Allowance for Combined Holdings of Oil and Gas Wells. The recoverable oil belonging to the taxpayer should be estimated for each property separately. The capital account for each property includes the cost or value, as the case may be, of the oil or gas lease or rights plus

all incidental costs of development not charged as expense nor returnable through depreciation. The unit value of the recoverable oil or gas for each property is the quotient obtained by dividing the capital account recoverable through depletion for each property by the estimated number of units of recoverable oil or gas on that property. This unit for each separate property multiplied by the number of units of oil or gas produced within the year by the taxpayer upon such property will determine the amount which may be deducted for depletion from the gross income of that year for that property. The total allowance for depletion of all the oil or gas properties of the taxpayer will be the sum of the amounts computed for each property separately: *Provided*, That in the case of gas properties the depletion allowance for each pool may be computed by using the combined capital account returnable through depletion of all the tracts of gas land owned by the taxpayer in the pool and the average decline in rock pressures of all the taxpayer's wells in such pool in the established formula. The total allowance for depletion in the gas properties of the taxpayer will be the sum of the amounts computed for each pool.[1]

[1] Reg. 45, Art. 214, as amended by T. D. 3055, Treasury Bulletin 35-20-1169. For the formula referred to see Reg. 45, Art. 211, T. D. 3064, Treasury Bulletin 38-20-1204.

[Page 464.]

DISCOVERY—PROVEN TRACT OR LEASE—PROPERTY DISPROPORTIONATE VALUE. 1. In determining the market value, for depletion purposes, of "property" upon which oil or gas wells have been discovered since March 1, 1913, the "private bounding lines," mentioned in subdivision (3) of this paragraph in the 1920 edition refer to the *exterior limit of a continuous tract held under lease or leases or in fee by the taxpayer*. To illustrate:

A company has leases upon the S. E. quarter of the N. W. quarter of section 10. The company holds this land under five separate leases from different fee owners. A well is brought in upon the land, conceded to be a discovery well, subsequent to the acquiring of the leases by the company, and so located as

to include the entire 40 acres of the company in the proven area. The property to be valued is the drill hole, the surface necessary for the drilling and operation of the well, the oil or gas content of this particular sand, zone, or reservoir, in which the discovery was made, to the limits of the entire 40 acres held by the company. If the "private bounding lines" were interpreted to mean the boundaries of each lease, it would enable the company to value one well subsequently brought in upon each of the five leases.

2. Wells drilled upon a proven tract which has already been re-valued upon discovery have no significance upon the value previously given the "property." But wells brought in upon a proven area still further extend the proven area. To illustrate:

A company owns an acreage of land upon which a discovery well is brought in, all of the proven area being included in the acreage. The company, for the purpose of ascertaining allowable deductions for depletion, determines the fair market value of the "well," i. e. (1) the drill hole, (2) the surface necessary for the drilling and operation of the well, and (3) the oil or gas content of the particular sand, zone, or reservoir, in which the discovery was made by the drilling, and from which the production is drawn. The great increase in value, of course, is from item (3), the oil or gas content of the sand, zone, or reservoir. If the company were allowed to value other wells brought in upon this proven area, it would in fact be valuing the same oil and gas content of the sand, zone, or reservoir, which had previously been valued and upon which depletion was being taken. Such a result would be distinctly contrary to the statute. However ,the bringing in of other wells upon this proven area, still further extends the proven area to the extent provided by law, and wells brought in upon an area so proven can not be revalued unless the land was acquired before proven.

3. If a well should be drilled in the corner of a quarter section of land owned by the taxpayer, to be able to value the portion of the quarter section not proven by the well, it would

be necessary for other wells to be brought in upon the area not proven by the first well.[1]

[1] O. D. 527, Treasury Bulletin 22-20-970. It is difficult to see the authority in the statute or any ground in equity for this ruling insofar as it precludes the taxpayer from revaluing acreage beyond the limits of the area proven by the first well by means of a well drilled in such proven area. The effect of the ruling is (1) to preclude a purchaser from claiming discovery value on the extended area proven beyond the limits of the original tract by additional wells drilled within those limits on the ground that such extended area is "a proven tract or lease" within the meaning of the law, and (2) to deny the right of the taxpayer to re-value the same extended area on the ground that as to him such extended area is not "proven" until discovery is actually made outside the limits of the original tract. There seems to be a valid reason for (1), but, if so, (2) is clearly inconsistent. The ruling, as it now stands, limits the application of the mathematical formula of a proven tract or lease according to the interest of the Government. If the formula is to be applied at all, it would seem only reasonable to apply it without discrimination. It is not difficult to conceive of cases in which, on account of geological or operating conditions, a taxpayer would drain the acreage outside the original tract without being able economically to drill outside such tract.

CHAPTER 30.

DEPLETION OF TIMBER

[Page 470.]

The regulations governing the deduction of an allowance for the depletion of timber have been thoroughly recast since the 1920 edition of this work. The present regulations are substantially repeated below:

[Pages 470-474.]

Capital Recoverable Through Depletion Allowance in the Case of Timber.[1] In general the capital remaining in any year recoverable through depletion allowances, may be determined as indicated in the chapter on "Depletion—In General" in the 1920 edition.[2] In the case of leases the apportionment of deductions between the lessor and lessee will be made, and the cost of timber properties should be determined, in accordance with the principles indicated in the same chapter. For depletion purposes the cost of the timber may not include any part of the cost of the land.[3]

[1] See Reg. 45, Art. 228, as amended by T. D. 3076, Treasury Bulletin 42-20-1246.

[2] See 1920 edition, pages 427-429.

[3] See 1920 edition, pages 429-430.

[Pages 470-474.]

Determination of Fair Market Value of Timber. Where the fair market value of the property at a specified date, in lieu of the cost thereof, is the basis for depletion and depreciation deductions, such value must be determined, subject to approval or revision by the Commissioner upon audit, by the owner of the property in the light of the most reliable and accurate information available with reference to the condition of the property as it existed at that date, regardless of all subsequent changes, such as changes in surrounding circumstances, in methods of exploitation, in degree of utilization, etc. The

value sought will be the selling price assuming a transfer between a willing seller and a willing buyer as of the particular date. Such factors as the following will be given due consideration: (a) Character and quality of the timber as determined by species, age, size, condition, etc.; (b) the quantity of timber per acre, the total quantity under consideration, and the location of the timber in question with reference to other timber; (c) accessibility of the timber (location with reference to distance from a common carrier, the topography and other features of the ground upon which the timber stands and over which it must be transported in process of exploitation, the probable cost of exploitation, and the climate and the state of industrial development of the locality); and (d) the freight rates by common carrier to important markets. The timber in question will be valued on its own merits, and not on the basis of general averages for regions; however, the value placed upon it, taking into consideration such factors as those mentioned above, will be consistent with that of the other timber in the region. The Commissioner will give due weight and consideration to any and all facts and evidence having a bearing on the market value, such as cost, actual sales and transfers of similar properties, the margin between the cost of production and the price realized for timber products, market value of stock or shares, royalties and rentals, value fixed by the owner for the purpose of the capital stock tax, valuation for local or State taxation, partnership accountings, records of litigation in which the value of the property has been involved, the amount at which the property may have been inventoried and/or appraised in probate or similar proceedings, disinterested appraisals by approved methods, and other factors. For depletion purposes the fair market value at a specified date may not include any part of the value of the land.[1]

[1] Reg. 45, Art. 234, as amended by T. D. 3076, Treasury Bulletin 42-20-1246.

[Pages 470-474.]

Determination of quantity of timber. Each taxpayer claiming or expecting to claim a deduction for depletion is required to estimate with respect to each separate timber account the

total units (feet board measure log scale, cords, or other units) of timber reasonably known or on good evidence believed to have existed on the ground on March 1, 1913, or on the date of acquisition of the property, as the case may be. This estimate must state as nearly as possible the number of units which would have been found present by a careful estimate made on the specified date with the object of determining 100% of the quantity of timber which the area would have produced on that date if all the merchantable timber had been cut and utilized in accordance with the standards of utilization prevailing in that region at that time. If, subsequently, during the ownership of the taxpayer making the return, as the net result of the growth of the timber, of changes in standards of utilization, of losses not otherwise accounted for, of abandonment of timber, and/or of errors in the original estimates, there are found to remain on the ground, available for utilization, more or less units of timber than remain in the timber account or accounts, a new estimate of the recoverable units of timber (but not of the cost or the fair market value at a specified date) must be made, and, when made, will thereafter constitute a basis for depletion.[1]

[1] Reg. 45, Art. 235, as amended by T. D. 3076, Treasury Bulletin 42-20-1246.

[Pages 470-474.]

Computation of Allowance for Depletion of Timber for Given Year. The allowance for depletion of timber in any taxable year should be based upon the number of units of timber felled during the year and the unit value of the timber in the timber account or accounts, pertaining to the timber cut. The unit value of the timber for a given timber account in a given year should be the quotient obtained by dividing (a) the total number of units of timber on hand in the given account at the beginning of the year plus the number of units acquired during the year plus (or minus) the number of units required to be added (or deducted) by way of correcting the estimate of the number of units remaining available in the account into (b) the total fair market value as of March 1, 1913 (and/or cost), of

the timber on hand at the beginning of the year, plus the cost of the number of units acquired during the year, plus proper additions to capital. The amount of the deduction for depletion in any taxable year with respect to a given timber account will be the product of (a) the number of units of timber cut from the given account during the year multiplied by (b) the unit value of the timber for the given account for the year. Those taxpayers, who keep their accounts on a monthly basis, may, at their option, keep their depletion accounts on a monthly basis, in which case the amount deductible on account of depletion for a given month will be determined in the manner outlined above for a given year. The total amount of the deduction for depletion in any taxable year will be the sum of the amounts deductible for the several timber accounts.

The depletion of timber takes place at the time the timber is felled. Since, however, it is not ordinarily practicable to determine the quantity of timber immediately after felling, depletion, for purposes of accounting, will be treated as taking place at the time, when, in the process of exploitation, the quantity of timber is first definitely determined.[1]

In the case of timber land acquired prior to March 1, 1913, depletion may be based on the average value on that date of all timber located in a single operation unit. In other words, the average value may be determined independently for each separate operation unit. A separate operation unit should include all timber which should logically be manufactured at a single definite mill site.[2]

[1] Reg. 45, Art. 229, as amended by T. D. 3076, Treasury Bulletin 42-20-1246.

[2] O. D. 43, Treasury Bulletin 1-19-60.

[Pages 470-474.]

Revaluation of Timber Not Allowed. In the case of timber acquired prior to March 1, 1913, the fair market value as of that date should, when determined and approved by the Commissioner, be the basis for determining the depletion deduction for each year during the continuance of the ownership under which the fair market value of the timber was fixed, and dur-

ing such ownership there may be no redetermination of the fair market value of the timber for such purpose. However, the unit market (or cost) value of the timber will subsequently be changed if from any cause such unit market (or cost) value, if continued as a basis of depletion, shall upon evidence satisfactory to the Commissioner be found inadequate or excessive for the extinguishment of the cost, or fair market value as of March 1, 1913, of the timber.[1]

[1] Reg. 45, Art. 230, as amended by T. D. 3076, Treasury Bulletin 42-20-1246.

[Pages 470-474.]

Charges to Capital and to Expenses in the Case of Timber. In the case of a timber property held for future operation by an owner having no substantial income from the property or from other sources, all expenditures for administration, protection, and other carrying charges prior to production on a normal basis must be charged to capital account; after such a property is on a normal production basis such expenditures should be treated as current operating expenses. In case a taxpayer, who has a substantial income from other sources, owns a timber property which is not yet on a normal production basis, he may, at his option, charge such expenditures with respect to such timber property to capital, or treat them as current operating expenses, but whichever system is adopted must be followed until permission to change to the other system is secured from the Commissioner. In the case of timber operations all expenditures prior to production for plants, improvements, and equipment, and thereafter all major items of plant and equipment must be charged to capital account for purposes of depreciation. After a timber operation has been developed and equipped and has reached its normal output capacity, the cost of additional minor items of equipment and the cost of replacement of minor items of worn-out and discarded plant and equipment may be charged to current operating expenses, unless the taxpayer elects to write off such expenditures through charges for depreciation;

however, the method adopted must be followed consistently from year to year.[1]

[1] Reg. 45, Art. 231, as amended by T. D. 3076, Treasury Bulletin 42-20-1246.

[Pages 470-474.]

Aggregating Timber and Land for Purposes of Valuation and Accounting. With a view to logical and reasonable valuation of timber, the taxpayer must include his timber in one or more accounts. In general, each such account should include all of the taxpayer's timber which is located in one "block," a "block" being an operation unit which includes all of the taxpayer's timber which would logically go to a single given point of manufacture. In those cases in which the point of manufacture is at a considerable distance or in which the logs or other products will probably be sold in a log or other market, the "block" may be a logging unit which includes all of the taxpayer's timber which would logically be removed by a single logging development. In exceptional cases, provided there are good and substantial reasons, and subject to approval or revision by the Commissioner on audit, the taxpayer may divide the timber in a given "block" into two or more accounts, e. g., timber owned on February 28, 1913, and that purchased subsequently, may be kept in separate accounts, or timber owned on February 28, 1913, and the timber purchased since that date in several distinct transactions may be kept in several distinct accounts, or individual tree species or groups of tree species may be carried in distinct accounts, or special timber products may be carried in distinct accounts, or "blocks" may be divided into two or more accounts based on the character of the timber and/or its accessibility, or scattered tracts may be included in separate accounts. When such a division is made a proper portion of the total value or cost, as the case may be, should be allocated to each account.

The timber accounts mentioned in the preceding paragraph may not include any part of the value or cost, as the case may be, of the land. In a manner similar to that prescribed in the foregoing part of this paragraph the land in a given "block"

may be carried in a single land account or may be divided into two or more accounts on the basis of its character and/or accessibility. When such a division is made, a proper portion of the total value or cost, as the case may be, will be allocated to each account.

The total value or total cost, as the case may be, of land and timber should be equitably allocated to the timber and land accounts, respectively.

Each of the several land and timber accounts carried on the books of the taxpayer must be definitely described as to their location on the ground either by maps or by legal descriptions.

For good and substantial reasons, to be approved by the Commissioner, or as required by the Commissioner, the timber or the land accounts may be readjusted by dividing individual accounts, by combining two or more accounts, or by dividing and recombining accounts.[1]

[1] Reg. 45, Art. 236, T. D. 3076, Treasury Bulletin 42-20-1246.

[Pages 470-474.]

Timber Depletion and Depreciation Accounts on Books. Every taxpayer claiming or expecting to claim a deduction for depletion and/or depreciation of timber property (including plants, improvements, and equipment used in connection therewith) must keep accurate ledger accounts in which should be charged the fair market value as of March 1, 1913, or the cost, as the case may be, of (a) the property, and (b) the plant, improvements, and equipment, together with such amounts subsequently expended for the administration, protection, and other carrying charges, or development of the property or additions to plant and equipment as are not chargeable to current operating expenses. In such accounts there should be set up separately the quantity of timber, the quantity of land, and the quantity of other resources, if any, and a proper part of the total value or cost should be allocated to each. These accounts should be credited with the amount of the depreciation and depletion deductions claimed and allowed each year, or the amount of the depreciation and depletion should be credited to depletion and depreciation reserve

accounts, to the end that when the sum of the credits for depletion and depreciation equals the value or cost of the property, plus the amount added thereto for administration, protection, and other carrying charges, or development or for additional plant and equipment, less salvage value of the physical property, no further deduction for depletion and depreciation will be allowed.[1]

[1] Reg. 45, Art. 237, T. D. 3076, Treasury Bulletin 42-20-1246.

[Pages 470-474.]

Information to Be Furnished by Taxpayer Claiming Depletion of Timber. To the income tax return of the taxpayer claiming a deduction for depletion or depreciation or both there must be attached a map and statement (Form T (timber)) for the taxable year covered by the income tax return. Form T (timber) requires the following: (a) Map showing timber and land acquired, timber cut, and timber and land sold; (b) description of, cost of, and terms of purchase or lease of, timber and land acquired; (c) proof of profit or loss from sale of capital assets; (d) description of timber with respect to which claim for loss, if any, is made; (e) record of timber cut; (f) changes in each timber account as the result of purchase, sale, cutting, reestimate, or loss; (g) changes in physical property accounts as the result of addition to or deductions from capital and depreciation; (h) operation data with respect to raw and finished materials handled and inventoried; (i) unit production costs; and (j) any other data which will be helpful in determining the reasonableness of the depletion and/or depreciation deductions claimed in the return. Similar information is required for certain years prior to the 1919 taxable year from those taxpayers who have not already furnished it . The specific nature of the information required for the earlier years is given in detail in "Form T—General Forest Industries Questionnaire for the years prior to 1919."[1]

[1] Reg. 45, Art. 233, as amended by T. D. 3076. Treasury Bulletin 42-20-1246.

CHAPTER 31.

NORMAL TAX CREDITS—PERSONAL EXEMPTION

[Page 475.]

Credit of Dividends. Where a town owns practically all of the common stock of a corporation organized to furnish it with water, light, power and heat, no dividends being paid thereon, the preferred stock to be redeemed as soon as possible out of earnings, after which the plant becomes the property of the town, the corporation is held to be exempt from income tax and dividends received by the preferred stockholders may not, therefore, be credited against net income.[1] Dividends of a foreign corporation whose income from sources within the United States is absorbed by deductions allocable to this country may be applied as a credit against net income by the stockholders of such corporation. The American stockholders of a foreign corporation whose entire income from sources within the United States consists of dividends from a corporation taxable upon its net income under the Revenue Act of 1918 are entitled to credit for purposes of the normal tax for the dividends received from such corporation.[2]

[1] O. D. 328, Treasury Bulletin 28-19-612.
[2] L. O. 1054, Treasury Bulletin 47-20-1314.

[Page 476.]

Footnote 5.

Add:—T. B. M. 21, Treasury Bulletin 5-19-252. The credit of dividends received from foreign corporations taxable on income from sources within the United States applies equally to the Revenue Acts of 1916, 1917, and 1918. The same credit is allowed to corporations under the Revenue Act of 1917, for the purpose of the 4 per cent. war income tax imposed by section 4 of that act, but not for the purpose of the 2 per cent. tax imposed by section 10 (a), Revenue Act of 1916 as amended by the Revenue Act of 1917. (O. D. 383, Treasury Bulletin 4-20-706.)

[Page 476.]

Personal and Specific Exemptions. The exemption of $3500 of the compensation received by persons in active service in the military or naval forces of the United States is in addition to the personal exemption and credit for dependents.[1]

[1] O. D. 123, Treasury Bulletin 3-19-184.

[Page 477.]

HEAD OF FAMILY. A widower who maintains a home and supports his daughter therein is held to be the head of a family notwithstanding that the daughter is over 18 years of age, receives nominal income from other sources, and is neither physically nor mentally incapable of self-support.[1] Where a widow has a child over 18 years of age who is away from home attending school, the child having separate income in excess of $1,000 a year but insufficient to pay half the cost of its support, the balance being contributed by the mother, who maintains the home, the child having made a return claiming an exemption of $1,000, the widow is considered the head of a family, and is entitled to a personal exemption of $2,000 in making her return. The fact that a child under such circumstances has separate income or receives support from other sources does not preclude the parent from claiming exemption as head of a family, provided the child is in a material degree dependent on the parent for support.[2] A daughter who actually supports her dependent mother elsewhere than in her own home, by reason of the fact that she is unable to earn enough to support them both in the mother's place of abode or to defray their joint expenses in the daughter's place of employment, is properly classifiable as head of a family.[3]

[1] O. D. 422, Treasury Bulletin 13-20-809.
[2] O. D. 474, Treasury Bulletin 17-20-886.
[3] O. D. 665, Treasury Bulletin 38-20-1205.

[Page 477.]

HUSBAND AND WIFE. Unavoidable absence of a wife, due to the war, will not preclude a husband from claiming the joint personal exemption of $2,000.[1] The separation of a hus-

[1] O. D. 357, Treasury Bulletin 1-20-657.

band and wife due to the fact that the husband has been declared mentally incompetent and confined in an institution for treatment, is held to be temporary in character and consequently without effect in so far as the joint personal exemption of $2,000 is concerned.[2] A resident alien with a wife and children living abroad is not entitled to a personal exemption of $2,000, but is entitled to a credit of $200 for each dependent child under 18 years of age or incapable of self-support.[3]

[2] O. D. 603, Treasury Bulletin 30-20-1089.
[3] O. D. 640, Treasury Bulletin 34-20-1149.

[Page 478.]

CREDIT FOR DEPENDENTS. An American citizen may claim the credit for dependents irrespective of the nationality or place of residence of the dependents.[1]

[1] O. D. 139, Treasury Bulletin 4-19-220.

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Footnote 16.
Add:—O. D. 105, Treasury Bulletin 2-19-154.

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Credits to Non-Resident Alien Individual. Where a country imposes an income tax but does not levy a tax on income derived from sources therein by citizens of the United States, a citizen of such country who is a non-resident of the United States is entitled to claim the credits for personal exemption and for dependents in his return of income derived from sources within the United States.[1]

[1] S. 969, Treasury Bulletin 2-19-153.

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WHEN NON-RESIDENT ALIEN INDIVIDUAL ENTITLED TO PERSONAL EXEMPTION. The following is an incomplete list of countries which either impose no income tax or in imposing an income tax allow both a personal exemption and a credit for dependents which satisfy the similar credit requirement of the statute: Argentina; Bahama Islands; Belgium; Bermuda; Bolivia; Bosnia; Brazil; Bukowina; Bulgaria; Canada; Carin-

thia; Carniola; China; Chile; Cuba; Czecho-Slovakia, including Bohemia, Moravia, and Slovakia; Dalmatia; Denmark; Ecuador; Egypt; France; Galicia; Goritz; Gradisca; Greece; Guatemala; Herzegovina; Istria; Jamaica; Lower Austria; Luxumberg; Lithuania; Mexico; Montenegro; Morocco; Newfoundland; Nicaragua; Norway; Panama; Paraguay; Persia; Peru; Porto Rico; Portugal; Roumania; Russia (including Poles owing allegiance to Russia); Salzburg; Santo Domingo; Serbia; Siam; Silesia; Styria; Spain; Switzerland; Trieste; Tyrol; Upper Austria; Union of South Africa; Venezuela. The following is an incomplete list of countries which in imposing an income tax allow a personal exemption which satisfies the similar credit requirement of the statute, but do not allow a credit for dependents: Austrian Poland; Bachka; Banat of Temesvar; Croatia; Finland; India; Italy; Prussian Poland; Salvador; Slavonia; Transylvania. The following is an incomplete list of countries which in imposing an income tax do not allow to citizens of the United States not residing in such country either a personal exemption or a credit for dependents and, therefore, fail entirely to satisfy the similar credit requirement of the statute: Australia; Costa Rica; Great Britain and Ireland; Japan; the Netherlands; New Zealand; Sweden. The former names of certain of these territories are here used for convenience, in spite of an actual or possible change in name or sovereignty. A non-resident alien individual who is a citizen or subject of any country in the first list is entitled for the purpose of the normal tax to such credit for a personal exemption and for dependents as his family status may warrant. If he is a citizen or subject of any country in the second list he is entitled to a credit for personal exemption, but to none for dependents. If he is a citizen or subject of any country in the third list he is not entitled to credit for either a personal exemption or for dependents. If he is a citizen or subject of a country which is in none of the lists, then to secure credit for either a personal exemption or for dependents he must prove to the satisfaction of the Commissioner that his country does not impose an income tax or that

in imposing an income tax it grants the similar credit required by the statute.[1] The foregoing provisions apply only to 1918 and subsequent years and have no application to the income tax of non-resident aliens for the year 1917.[2]

In order that a non-resident alien may prove that his country satisfies the similar credit requirement of the income tax law, he should submit to the Commissioner a copy of the income tax laws of his native country, or an official communication from an accredited diplomatic representative of such country, showing that the country imposes no income tax, or in doing so grants similar credits required by statute.[3]

The right of a non-resident alien as to the United States to personal exemption and credit for dependents is contingent primarily on his citizenship. For example, a native-born Russian, especially one who has been living in the United States for a number of years, would still be regarded by this country as a citizen of Russia. This is rebuttable, however, by evidence of citizenship in Poland; and if an individual has in fact become a citizen of the new State, inasmuch as Poland is not included in the countries enumerated above, it will be necessary for him to comply with the above requirements as to proof to the Commissioner in order to secure the benefit of the exemptions provided.[4] The provisions granting personal exemption and credit for dependents to citizens and subjects of the countries enumerated above are retroactive and are applicable to the year 1918 as well as 1919, except where the classification of a country has been changed because of a change in the law of such country. In cases where excess

[1] Reg. 45, Art. 307, as amended by T. D. 2970; O. D. 466, Treasury Bulletin 16-20-864; O. D. 437, Treasury Bulletin 14-20-831; O. D. 580, Treasury Bulletin 28-20-1056. In the case of Greece, the personal exemption and credit for dependents are allowable only for 1919 and subsequent years (O. D. 300, Treasury Bulletin 24-19-567); O. D. 547, Treasury Bulletin 24-20-1004; O. D. 322, Treasury Bulletin 27-19-603; O. D. 548, Treasury Bulletin 24-20-1005; O. D. 364, Treasury Bulletin 2-20-675; O. D. 605, Treasury Bulletin 30-20-1091; O. D. 350, Treasury Bulletin 31-19-648; O. D. 630, Treasury Bulletin 33-20-1133.

[2] O. D. 301, Treasury Bulletin 24-19-568.

[3] O. D. 253, Treasury Bulletin 15-19-446.

[4] O. D. 346, Treasury Bulletin 30-19-642.

income tax has been paid for the year 1918, due to the official data not having been received by the Commissioner in regard to personal exemption, claims for refund on Form No. 46 should be filed with the collector to whom the income tax was paid.[5]

[5] O. D. 391, Treasury Bulletin 5-20-718.

CHAPTER 32.

CREDIT FOR TAXES

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Citizens of the United States. The credit for taxes only applies to income, war-profits, and excess-profits taxes paid or accrued to any foreign country upon income derived *from sources in such foreign country.*[1] If the taxpayer's books are kept on an accrual basis and his returns are so rendered, the credit for taxes paid to a foreign country on income received from sources therein is limited to taxes accrued in the taxable year for which the return is rendered.[2]

[1] O. D. 317, Treasury Bulletin 26-20-593.
[2] O. 987, Treasury Bulletin 7-20-743.

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Resident Aliens. The following is an incomplete list of the countries which satisfy the similar credit requirement of the Statute: Bulgaria, Canada, Italy, Newfoundland, Salvador. The following is an incomplete list of the countries which do not satisfy the similar credit requirement of the Statute: Argentina, Bahama, Belgium, Bermuda, Bolivia, Bosnia, Brazil, Chile, China, Costa Rica, Ecuador, Egypt, Finland, France, Great Britain and Ireland, Guatemala, Herzegovina, India, Jamaica, Japan, Montenegro, Morocco, New Zealand, Nicaragua, Panama, Paraguay, Persia, Peru, Portugal, Roumania, Santo Domingo, Serbia, Siam, Sweden, Switzerland, Venezuela. The former names of certain of these territories are here used for convenience in spite of the actual or possible change in the name or sovereignty. A resident of the United States who is a citizen or subject of any country in the first list is entitled, for the purpose of the total tax due to the United States, for 1918 and subsequent years, to a credit for the amount of any income, war profits and excess profits taxes paid or accrued during the taxable year to such country upon

income from sources therein. If he is a citizen or subject of any country in the second list he is not entitled to such credit. If he is a citizen or subject of a country which is in neither list, then to secure the desired credit, he must prove to the satisfaction of the Commissioner that his country satisfies the similar credit requirement of the statute.[1]

[1] T. D. 3060, Treasury Bulletin 36-20-1186, revoking T. D. 3028, Treasury Bulletin 24-20-1008, and adding Reg. 45, Art. 385. See also O. D. 580, Treasury Bulletin 28-20-1056; O. D. 393, Treasury Bulletin 5-20-720; O. D. 424, Treasury Bulletin 13-20-813; O. D. 499, Treasury Bulletin 19-20-922.

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Domestic Corporations. The tax imposed by the Republic of Cuba on all corporations operating sugar plantations therein, is based on production, not on income, and is in the nature of an excise tax. Domestic corporations may not credit the amount of such taxes against the total tax due the United States.[1]

[1] O. D. 372, Treasury Bulletin 3-20-688.

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Domestic Corporations Owning Stock of Foreign Corporations. Taxes imposed and required by a foreign Government to be paid on the basis of dividends declared by corporations under its laws are taxes on the income of the individual stockholders in proportion to the amount of stock held. A domestic corporation owning stock in a foreign corporation taxed on this basis should report in its return of annual net income for the year in which received its pro rata share of the entire dividend declared, and would be entitled to a credit of the amount of the tax paid by the foreign corporation to the foreign Government in its behalf.

On the other hand, taxes imposed by a foreign Government on the net income of corporations organized under its laws are not taxes to the individual stockholders, but to the corporation itself, and no part thereof would be a proper credit in the return of annual net income of the recipient domestic

corporation, which would be taxable on the entire amount of the dividend received.[1]

[1] O. D. 147, Treasury Bulletin 4-19-230.

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Conditions of Allowance of Credit. In a case in which a domestic partnership leases certain patents to a British licensee for a fixed royalty, the British Government requiring the licensee to withhold and pay to it a British income tax on the royalty payments, the partners, in order to obtain credit for such tax paid to the British Government, should attach to the partnership return a claim for credit on Form 1118, modified throughout by substituting the word "partnership" for the word "corporation." In lieu of the required receipt or return, a copy of the receipt issued to the British licensee duly attested by the president of the British licensee will be accepted. The individual members of the partnership are required to attach Form 1116 to their individual returns, accompanied by a copy of the receipt issued to the British licensee and a copy of the attesting affidavit made by the president of the British licensee.[1] Where under a foreign income tax law corporations are required to withhold a fixed percentage of the total amount of dividends paid to the stockholders in this country, such tax being withheld in a lump sum, although imposed upon the individual stockholders, the amounts withheld not being itemized by the foreign Government, in lieu of the individual tax receipts required to be attached to Form 1116, the taxpayer may attach to the return on Form 1116 his affidavit showing the number of shares held during the year, whether or not any of the shares held by him were acquired or sold during the year, giving dates and number of shares so acquired or sold; the total number of shares outstanding on which the dividend was declared, regardless of whether the dividend was paid to citizens of the United States or other Governments; and the total dividends paid or accrued on such shares during the year, and attach to and make a part of such affidavit a certified copy of the tax receipts from the

[1] O. D. 583, Treasury Bulletin 28-20-1059.

foreign tax collector showing the payment of the tax *en bloc,* with copies of any other documents which he may have that will serve to corroborate the facts set forth in such affidavit. The amount of the credit claimed should be computed by dividing the total tax withheld by the total number of shares of the corporation outstanding and multiplying this result by the number of shares held during the entire year. In the event that any of the shares were acquired or disposed of during the year, an adjustment should be made showing the amount of taxes properly allocated to the dividends received after acquisition or before disposition of the stock.[2]

When credit is claimed by an American bank for the amount of tax withheld from interest on bank deposits and paid to a foreign Government by a foreign bank, there should be attached to and filed with Form 1118, an affidavit from the foreign withholding agent. The affidavit should set forth the title of the statute under which such withholding was required, the amount of interest accrued to the American bank and the amount of tax withheld and paid to the foreign Government.[3]

[2] O. D. 232, Treasury Bulletin 12-19-407.
[3] O. D. 671, Treasury Bulletin 39-20-1213.

CHAPTER 33.

METHODS AND PERIODS OF ACCOUNTING

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Reporting Income Upon Accrual Basis. Mercantile corporations are required to file returns upon the accrual basis. In the case of such corporations which carry a substantial stock of merchandise, the inventories of the stock on hand at the beginning and end of the taxable year must be included in the computation and determination of net income for that period; when a business is carried on mainly through sales on credit no return of income and profits for a taxable year is accurate and complete without considering the accounts receivable.[1]

[1] A. R. R. 217, Treasury Bulletin 32-20-1115. This ruling also held the provisions of Sec. 13 (d) of the Revenue Act of 1916 did not give a corporation keeping its accounts on the accrual basis the option of making a return either on that basis or on the basis of actual receipts.

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WHEN ITEMS SHOULD BE REPORTED. One of the most perplexing difficulties arising under a law which imposes a tax upon income with respect to a definite or fixed period of time is the question when under a given set of circumstances, an item of income or a particular deduction should be reported. This question is dealt with at some length in the 1920 edition under the subject of "Income" on pages 225-231, and under the subject of "Deductions" on page 332. Various cases in which the question has been more or less directly involved are also dealt with in other parts of the 1920 edition as they arise in connection with some other subject.

This supplement will contain a discussion of a number of cases and rulings also involving the question in what taxable period items of income or particular deductions should be reported. This discussion is somewhat scattered in accordance

with the general scheme of presentation used in writing the 1920 edition. This discussion is particularly to be found in the chapter on "Income from Services" and "Losses."

It is stated in the 1920 edition, following the regulations, that the time as of which any item of gross income or any deduction is to be accounted for must be determined in the light of the fundamental rule that the computation must be made in such manner as clearly reflects the taxpayer's income. The essence of this rather vague rule is that gross income should ordinarily be reported in the taxable year in which received by the taxpayer, unless he keeps his accounts upon the accrual basis, in which event items should be reported as accrued according to recognized accounting practices. Similarly, deductions should be taken when payment of charges is made or when charges accrue, as the case may be. As a general rule, statutory deductions are expenditures other than capital expenditures *connected with* the production of income.[1] The artificiality of the taxable year as the unit of time will often, if strictly adhered to, result in the reporting of deductions in one year which are *connected with* another year's income. It would, however, be utterly impracticable for the Government to proceed in all cases upon the theory that losses and expenses must be charged back against the income of the year in which the operation occurred giving rise to the losses and expenses.[2] This would mean that "the administration of the taxing acts would be an interminable accounting proposition." Moreover in many cases, a transaction in one year may or may not produce income according to the outcome of subsequent developments. This was particularly true in the period of unusual conditions prevailing at the close of 1918 when it was recognized that many items of gross income such as claims for compensation under cancelled contracts together with claims against contracting departments of the Government for amortization and other matters while properly constituting gross income for the taxable year 1918 were undecided and not sufficiently definite in amount to be reported in the orig-

[1] Reg. 45, Art. 21.

[2] S. 983, Treasury Bulletin 3-19-188.

inal return for that year.[3] Another distinction to be kept in mind is that existing between the constructive receipt and the accrual of income. These and other factors introduce further complexities into the question of when items should be reported. Various cases in which the question of when items should be reported has arisen are briefly reviewed below:

1. Adjustments made in accordance with instructions from the Interstate Commerce Commission, increasing the income of a railroad corporation from transactions in prior years and taken up on the books of the corporation during the taxable year because necessary information was not available prior to that time, represent income for the years during which the transactions took place instead of the taxable year. Corrections should be made by means of amended returns.[4]

2. A corporation assigned its principal asset, a mortgage, to trustees in trust for its stockholders and then instituted liquidation proceedings. The mortgage was payable in annual installments with interest, and the beneficiaries were to receive proportionate shares of the principal and interest as paid to the trustees. The trustees were to receive compensation in a fixed amount plus a percentage of the income received and distributed, and be reimbursed for expenses incurred in connection with the trust. It was held that the profit of the stockholders from the surrender of their stock is not definitely ascertainable, and they need not report any amount as income until the total sum received in liquidation exceeds either the cost of their stock or its fair market value March 1, 1913, if acquired prior to that date.[5]

3. An award in the year 1918 by a Board of Arbitration on an unliquidated claim to a portion of the proceeds arising out of transactions which took place in 1917, is income for the year 1918 rather than 1917.[6]

4. Profit on goods sold by a consignee is income to the consignor for the year in which the sales are made, even

[3] Reg. 45, Art. 52.

[4] O. D. 9, Treasury Bulletin 1-19-18.

[5] O. D. 461, Treasury Bulletin 16-20-874.

[6] S. 1335, Treasury Bulletin 8-20-750. See O. D. 591, Treasury Bulletin 29-20-1071.

though the consignor received no notification of sale until a subsequent year. If reported otherwise, amended returns should be filed.[7]

5. Where in connection with the reorganization of a company the stockholder has the right to make an exchange in one year but does not actually make the exchange until the following year, the profit accruing is income in the year in which the exchange is actually made.[8]

6. As a general rule, salaries or compensation for personal services are income for the year in which received irrespective of the period in which earned. The distinction between constructive receipt and accrual should be carefully noted in connection with salary or compensation payments.[9]

7. When property is sold by individuals who are under agreement to incorporate at a later date, the proceeds of the sale being placed on deposit in a bank in escrow under the condition that the sale must be ratified by the directors of the corporation when organized, income accrues to the corporation at the time when the sale is ratified and the funds in escrow are made available to the company.[10]

8. Where a sale is made and because of claimants for commissions the seller is required by the purchaser to put a certain part of the purchase price in escrow, and thereafter certain claimants are paid directly out of said funds in escrow, the seller is not liable for income tax upon any part of the purchase price in escrow until actually received by him.[11]

9. A report of a master in chancery, appointed by an interlocutory decree in a suit for damages for alleged infringement

[7] O. D. 13, Treasury Bulletin 1-19-25.

[8] A. R. K. 289, Treasury Bulletin 44-20-1274.

[9] T. B. R. 12, Treasury Bulletin 3-19-178; A. R. R. 182, Treasury Bulletin 29-20-1070; O. D. 717, Treasury Bulletin 45-20-1289; O. D. 432, Treasury Bulletin 14-20-824; O. D. 19, Treasury Bulletin 1-19-31; O. D. 512, Treasury Bulletin 21-20-948; Jackson v. Smietanka, Dist. Ct. No. Dist. Ill., E. D.; T. D. 2960; State ex rel. Houghton v. Phelps (Wis.), 176 N. W. 217. See Chap. 15 on Income From Personal Services.

[10] O. D. 282, Treasury Bulletin 21-19-523. This case involves the doctrine of constructive receipt.

[11] S. 1315, Treasury Bulletin 6-20-725. This case involves the doctrine of constructive receipt.

of a patent, assessing damages against the taxpayer, which report was filed during the taxable year, but was not confirmed until the following year when judgment was entered on the report, can not be regarded as a determination of the amount of the claim, and no deduction for the taxable year is permissible in regard to the judgment referred to.[12]

10. Where a corporation pays liquidated damages to be relieved from the terms of a contract which called for the delivery of merchandise in 1918 and 1919, the loss so incurred is deductible from gross income for the year 1919 rather than 1918.[13]

11. In the case of a partnership keeping its books on the accrual basis which was required to pay an injured employee a sum in weekly installments extending over several years it was held that the entire sum payable is not such an item as may be properly accrued in its entirety upon the books of the partnership at the time the award was rendered for the purpose of claiming a deduction in computing net income. Only the installments actually accrued by time elapsed, whether paid or unpaid as at the end of the taxable year, are properly deductible in computing net income for that year.[14]

12. When additional compensation is agreed to be paid by a corporation to its officers at a future date, upon the happening of certain contingencies expected to result from the rendition of services the amount of such compensation being left for future determination, the amount eventually so paid is not to be treated as back salary and allocated to the years during which the services were rendered, but constitutes a business expense to the corporation for the taxable year in which the same was paid.[15]

13. A corporation sold merchandise, the weight and grade of which was guaranteed under contract. Under the practice of the trade, when shipments failed to conform to specifications, adjustments were made in accordance with rules promulgated by certain trade associations. Referring to certain

[12] S. 923, Treasury Bulletin 1-19-94.
[13] S. 983, Treasury Bulletin 3-19-188.
[14] O. D. 686, Treasury Bulletin 42-20-1243.
[15] A. R. R. 232, Treasury Bulletin 33-20-1130.

shipments made toward the close of a taxable period and finally adjusted after the end of the taxable period, it has been ruled that if the liability of the taxpayer were in question, there would have been no deductible loss until such liability had been actually determined, either by agreement or in the courts, but where such liability is not in dispute and the amount thereof is merely an accounting detail to be determined under an existing contract or agreement, and in accordance with a clearly recognized course of procedure, there can be no question but that such adjustments are applicable to the year in which the sales were made and should be regarded more truly as adjustments of the selling price rather than as rebates or allowances.[16]

14. A corporation may set up on its books in 1918 a contingent liability without prejudicing its right to deduct the item in a proper year, although the same is not deductible in 1918.[17]

Other rulings upon this general principle are given in the footnote below.[18]

[16] A. R. R. 275, Treasury Bulletin 42-20-1242.

[17] O. D. 159, Treasury Bulletin 5-19-260.

[18] O. D. 728, Treasury Bulletin 46-20-1302; Sol. Op. 41, Treasury Bulletin 34-20-1159.

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FIRST RETURNS. The first taxable year of a corporation organized in 1918 which established a recognized fiscal year not ending in 1918 after its organization is its fiscal year ending in 1919.[1] A newly organized corporation may file its return on a fiscal year basis without applying for permission to do so, provided such basis is definitely established and the books are kept in accordance therewith prior to the close of the first fiscal year.[2]

[1] S. 930, Treasury Bulletin 1-19-3.

[2] O. D. 404, Treasury Bulletin 8-20-749.

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CHANGE IN ACCOUNTING PERIOD. The limitation stated in (b) of the 1920 edition has now been changed to "at least

thirty days before the due date of his separate return for the period between the close of the existing taxable year and the date designated as the close of the proposed taxable year." The due date of the separate return for such period is the fifteenth day of the third month following the close of that period.[1] A company which earned a large income during the fiscal year ended September 30, 1918, and suffered a net loss during the year ended September 30, 1919, will not be permitted to change its accounting period for 1918 to the calendar year basis so as to be allowed to deduct the net loss from 1918 income. The accounting period for which the tax liability had accrued and the method of accounting during that period were accomplished facts which could not thereafter be changed by the Commissioner.[2] For the purpose of giving notice of a change in an accounting period, the term "due date" means the original due date of the return and not the date on which the return should be filed in case an extension of time has been granted.[3] A taxpayer having made a return upon the basis of the business year best adapted to reflect his true income should not be permitted to depart from that return year.[4]

Permission will not be granted to an employee of a partnership (not a partner) receiving part of his salary in the form of a share in the profits of the partnership to make his returns upon the basis of the fiscal year of the partnership.[5] Where a taxpayer has been permitted to change his accounting period from the calendar to a fiscal year and renders a return for the period from January 1 to the end of such fiscal year, both the normal tax and the surtax will be computed as though the return were filed for a full twelve-month period after the reduction of the exemptions and credits.[6]

[1] Reg. 45, Art. 26, as amended by T. D. 3032, Treasury Bulletin 26-20-1026; Sol. Op. 5, Treasury Bulletin 24-20-996.

[2] T. D. 3044, Treasury Bulletin 30-20-1087.

[3] O. D. 205, Treasury Bulletin 10-19-355.

[4] T. B. R. 37, Treasury Bulletin 11-19-370.

[5] O. D. 696, Treasury Bulletin 43-20-1257.

[6] O. D. 723, Treasury Bulletin 45-20-1296.

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Footnote 23.

Add:—Though the income tax return of a corporation filed in accordance with the Revenue Act of 1917 for a fiscal year ended in 1918 shows a loss, the corporation will nevertheless be required to file a supplementary return in accordance with the Revenue Act of 1918 for such fiscal year. (O. D. 71, Treasury Bulletin 1-19-100.)

CHAPTER 34.

RETURNS OF INCOME

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MINORS. Where a father has made a *bona fide* and absolute gift of property to his minor child, the income therefrom need not be included in the father's return of gross income even though the father administers the property and collects the income for the child. In such a transaction there is no presumption that the gift is or is not *bona fide,* but the burden will be upon the father in each case to show that it is an absolute gift to the child.[1]

[1] Sol. Op. 14, Treasury Bulletin 31-20-1100.

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Footnote 9.

Bristor v. Chicago, etc., 128 Iowa 479, 104 N. W. 487. Although under the common law a father is entitled to the services of his unemancipated minor children (The Hattie Law, 14 Fed. 880) and to money paid them for such services by others (Allen v. Allen, 60 Mich. 635, 27 N. W. 702), he is not entitled to his children's income from separate estates (Wheeler v. St. Joseph, 31 Kans. 640, 3 Pac. 297; Hillebrant v. Brewer, 6 Tex. 45; Grangiac v. Arden, 10 Johns. (N. Y.) 293; Boobier v. Boobier, 39 Maine 406; Mears v. Bickford, 55 Maine 528). When a father receives income from his children's separate estates he must account therefor as a trustee. See Darlington v. Turner, 202 U. S. 195.

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Returns When Accounting Period Changed. An alien who arrived in the United States on September 1, 1919, and who actually keeps his books of account on a fiscal year basis ending August 31, is required to render a return on the basis of such fiscal year. Notice that he maintains an accounting period for the fiscal year ending August 31, should be given to the collector for the district in which the alien resides.[1]

[1] O. D. 456, Treasury Bulletin 15-20-853.

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EXTENSION OF TIME BY COLLECTOR. If a taxpayer has filed a tentative return for any taxable year or has paid any amount to a collector on the supposition that he will be liable for payment of tax, and later finds that his income was insufficient to require a return, a statement under oath to that effect should be filed in lieu of a complete return. If the taxpayer desires to file a claim for refund of the amount erroneously paid, a complete return will be required.[1] Where the time for filing a return has been extended by the Commissioner beyond the original due date, or beyond a period of extension granted by a collector, the collector is without authority to grant a further extension, regardless of whether or not a tentative return has been filed.[2]

[1] O. D. 347, Treasury Bulletin 30-19-643.
[2] O. D. 650, Treasury Bulletin 35-20-1171.

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EXTENSION OF TIME BY COMMISSIONER. The acceptance of tentative returns by the use of Form 1040-T and 1031-T will not be permitted in the case of taxpayers filing returns for a fiscal year ending in 1920 except in extraordinary cases on the specific authorization of the Commissioner. Any request for permission to file tentative returns should be addressed to the Commissioner and should state clearly the reasons why it is impossible to file complete returns on time.[1] Where a husband and wife file a joint return and an extension of time has been granted to either of them, the benefit of the extension inures to both and it will be unnecessary for the other party to secure additional authority.[2]

[1] M. 2383, Treasury Bulletin 4-20-707.
[2] O. D. 521, Treasury Bulletin 21-20-959.

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Footnote 34.

O. 809, Treasury Bulletin 2-19-160; O. D. 443, Treasury Bulletin 14-20-839.

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Verification of Returns. The words "before an officer duly authorized to administer oaths either by the laws of the United States or by the laws of the State," with respect to the verification of returns, signify an officer duly authorized to administer oaths generally, rather than an officer authorized to administer oaths only under special circumstances. Postmasters, therefore, while admittedly "duly authorized to administer oaths * * * by the laws of the United States" in a limited field, have no authority to administer oaths in general, and, possessing no specific authority for that purpose, can not properly administer oaths to taxpayers when filing returns of income.[1]

[1] O. D. 701, Treasury Bulletin 43-20-1263.

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Footnote 44.

U. S. v. Benowitz, 262 Fed. 223.

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VERIFICATION ABROAD. American citizens in China executing their income tax returns may, when the services of a notary are not available, attach to their returns Consular Form 180, properly adapted, and made a part of their tax returns.[1]

[1] O. D. 189, Treasury Bulletin 8-19-327.

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Inspection of Returns by the Public. The executive order of the President under date of July 28, 1914, that returns should be subject to inspection in accordance with certain rules and regulations prescribed by the Secretary of the Treasury of the same date has now been superseded by new regulations issued by the Secretary of the Treasury and approved by the President.[1] The succeeding paragraphs in the 1920 edition concerning inspection of returns are now superseded by the new regulations which deal only with *inspection* of returns. The word "return," unless otherwise indicated, includes income and profits tax and also capital stock tax returns.

[1] T. D. 2961; T. D. 2962.

Written statements filed with the Commissioner designed to be supplemental to and to become a part of tax returns will be subject to the same rules and regulations as to inspection as are the returns themselves.[2]

Except as hereinafter specifically indicated, the Commissioner may, in his discretion, upon written application setting forth fully the reasons for the request, grant permission for the inspection. The application will be considered by the Commissioner and a decision reached by him whether the applicant has met the conditions imposed and whether the reasons advanced for permission to inspect are sufficient to permit the inspection. Such written application is not required of the officers and employees of the Treasury Department whose official duties require inspection of a return, or of the Solicitor of Internal Revenue. When it becomes necessary for the Department to furnish returns or copies thereof for use in legal proceedings, inspection of such returns or copies that necessarily results from such use is permitted. Except as indicated above, returns may be inspected only in the office of the Commissioner at Washington. A person who is permitted to inspect a return may make and take a copy thereof or a memorandum of data contained therein.[3]

[2] A debtor corporation may not inspect ownership certificates executed by owners of its bonds or bonds of its subsidiaries after such certificates have been forwarded to the Commissioner by the debtor corporation. (S. 1301, Treasury Bulletin 6-20-434.)

[3] T. D. 2961.

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Footnote 62.

T. D. 2903, Treasury Bulletin 15-19-451.

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RETURNS OF INDIVIDUALS. The return of an individual is open to inspection as follows: (a) By the officers and employees of the Treasury Department whose official duties require such inspection and by the Solicitor of Internal Revenue; (b) by the person who made the return, or by his duly constituted attorney-in-fact; (c) by the administrator, execu-

tor or trustee of the taxpayer's estate, or by the duly constituted attorney-in-fact of such administrator, executor or trustee, where the maker of the return has died,[1] and (d) in the discretion of the Commissioner, by one of the heirs at law or next of kin of such deceased person upon showing that he has a material interest which will be affected by information contained in the return.

An original letter with regard to his return written by a decedent to the collector may not be furnished to the attorneys for the estate. A certified or photostatic copy may, however, be given to them provided the executors submit a copy of the letters testamentary issued to them by the court, together with a letter signed by them authorizing the attorneys to receive a copy of the letter in question.[2]

A joint return of a husband and wife will be open to inspection (a) by the officers and employees of the Treasury Department whose official duties require such inspection, and by the Solicitor of Internal Revenue; and (b) by either spouse for whom the return was made, or his or her duly constituted attorney, upon satisfactory evidence of such relationship.[3]

[1] The executor of an estate may secure copies of income tax returns filed by the decedent upon submission to the Commissioner of a certified copy of letters testamentary evidencing his appointment as executor. (O. D. 355, Treasury Bulletin 31-19-654.)

[2] O. D. 576, Treasury Bulletin 27-20-1046.

[3] T. D. 2961.

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RETURNS OF PARTNERSHIPS. The return of a partnership will be open to inspection (a) by the officers and employees of the Treasury Department whose official duties require such inspection and by the Solicitor of Internal Revenue; and (b) by any individual (or his duly constituted attorney-in-fact, or legal representative) who was a member of such partnership during any part of the time covered by the return, upon satisfactory evidence of such fact.[1]

[1] T. D. 2961.

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RETURNS OF CORPORATIONS. The return of a corporation will be open to inspection (a) by the officers and employees of the Treasury Department whose official duties require such inspection and by the Solicitor of Internal Revenue; (b) upon satisfactory evidence of identity and official position, by the president, vice-president, secretary or treasurer of such corporation or if none, its principal officer; and (c) by a stockholder of record owning one per centum or more of the outstanding stock of such corporation as provided below.

A stockholder of record owning one per centum or more of the stock of the outstanding stock of a corporation may be permitted to inspect its return. Such permission will only be granted upon an application in writing to the Commissioner accompanied by an affidavit showing applicant's address, the name of the corporation, the period of time covered by the return he desires to inspect, and a certificate from the officials of the corporation or other satisfactory evidence showing the amount of the corporation's outstanding capital stock, the number of shares owned by the applicant, the date when such stock was acquired, and satisfactory proof of identity. This privilege of inspection is personal and will be granted only to the stockholder. This rule has no application to the return of a corporation filed pursuant to the Revenue Act of 1918; specific provision, independent of Presidential regulation, being made in that act for inspection by a stockholder of a return of a corporation filed thereunder.[1] A *bona fide* stockholder[2] of record owning one per centum or more of the outstanding stock of a corporation shall be entitled as of right, upon making request of the Commissioner, to examine the annual income war-profits, excess-profits, and capital stock tax returns of such corporation and of its subsidiaries made under the Revenue Act of 1918. His request for permission to examine such returns must be made in writing and must be in the form of

[1] T. D. 2961; Revenue Act of 1918, Section 257.

[2] A "stockholders protective committee," to which deposited stock has been transferred for the purpose of safeguarding the interests of the minority stockholders, is not considered a *bona fide* stockholder. (O. D. 273, Treasury Bulletin 18-19-490.)

an affidavit showing his address, the name of the corporation, the period of time covered by the return he desires to inspect, the amount of the corporation's outstanding capital stock, the number of shares owned by him, the date when he acquired them and whether he has the beneficial as well as the record title to such shares. It must also show that he has not acquired his shares for the purpose of the examination of the income returns of the corporation. If he has acquired them for this purpose he is not a *bona fide* stockholder within the meaning of the statute. The application must be supported by satisfactory evidence showing that the applicant is a *bona fide* stockholder of record of the required amount of stock of the corporation. The supporting evidence may be partly in the form of a certificate signed by the president or vice-president of the corporation, and countersigned by the secretary under the corporate seal. Upon being satisfied from the evidence presented that the applicant has fully met these conditions the Commissioner will grant the permission to examine the returns and set a convenient time for the examination in the office of the Commissioner. This privilege is personal and will be granted only to the stockholder, who cannot delegate it to another.[3]

[3] Revenue Act of 1918, Section 257; T. D. 2962.

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Inspection of Returns by Government Officers. When the head of an executive department (other than the Treasury Department) or of any other United States Government establishment, desires to inspect or to have some other officer or employee of his branch of the service inspect a return in connection with some matter officially before him, the inspection may, in the discretion of the Secretary of the Treasury, be permitted upon written application to him by the head of such executive department of other Government establishment. The application must be signed by such head and must show in detail why the inspection is desired, the name and address of the taxpayer who made the return, and the name and official designation of the one it is desired shall inspect the

return. When the head of a bureau or office in the Treasury Department, not a part of the Internal Revenue Bureau, desires to inspect a return in connection with some matter officially before him, other than an income, profits tax or corporation excise tax matter, the inspection may, in the discretion of the Secretary, be permitted upon written application to him by the head of such bureau or office showing in detail why the inspection is desired. The reasons submitted for permission to inspect as provided in this paragraph will be considered by the Secretary and a decision reached by him whether the reasons are sufficient to permit the inspection.[1]

[1] T. D. 2961.

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Inspection of Corporation Returns by State Officers. The proper officers of a State imposing an income tax are entitled as of right upon the request of its governor to have access to the income and profits tax returns of a corporation, association, joint-stock company or insurance company or to an abstract thereof showing its name and income. Proper officers in this connection are only those officers of the State who are charged with the enforcement of the State income tax law and who are to use the information gained by the access only in connection with such enforcement. The request or application of the governor must be in writing signed by him under the seal of his State and must show: (a) That the State imposes an income tax. (b) The name and address of the corporation, association, joint-stock company, or insurance company making the returns to which access is desired. (c) Why access is desired. (d) The names and official positions of the officers designated to have the access. (e) That such designated officers are charged with the enforcement of the State income tax law. (f) That the information to be gained by the access is to be used only in connection with such enforcement. The request or application of the governor may be addressed either to the Secretary of the Treasury or to the Commissioner but should be transmitted to the Commissioner who will set a convenient time for the access to

the returns (or to an abstract thereof as he may determine). Access will be given only in the office of the Commissioner in Washington. The officers designated by the governor will not be permitted to name another person or persons to examine the returns (or abstracts) for them. The officers designated will be given access only to the returns of those corporations, associations, joint-stock companies, or insurance companies organized or doing business in their State. The officers designated may have access to lists furnished to supplement and become a part of the returns to which they are given access. The proper officers, as defined above, may have access to the capital stock tax returns filed under the provisions of the Revenue Act of 1918 under the same conditions prescribed above for access to the income and profits tax returns of corporations, associations, joint-stock companies, and insurance companies. This right does not extend to the examination of capital stock tax returns filed pursuant to prior acts of Congress.[1]

[1] T. D. 2962.

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Furnishing Copies of Returns. No specific provision is made in the statutes for furnishing a copy of an income return to any one. Authority to permit inspection does not carry with it authority to furnish a copy. Implied authority to furnish a copy is contained in several provisions of law constituting returns public records, and in Sections 161 and 251 R. S., which confer upon the Secretary of the Treasury broad power to make rules and regulations concerning "custody, use and preservation of the records, papers and property" of the Department and the enforcement of the Internal Revenue laws. Because of the provisions contained in Section 3167 R. S., as amended by the Revenue Act of 1918, making it unlawful for any officer or employee of the United States "to divulge or to make known in any manner whatever not provided by law to any person * * * the amount or source of income, profits, losses, expenditures, or any particular thereof, set forth or disclosed in any income return, or to permit any income return

or copy thereof or any book containing any abstract or particulars thereof to be seen or examined by any person except as provided by law;" and also unlawful "for any person to print or publish in any manner whatever not provided by law any income return, or any part thereof or source of income, profits, losses, or expenditures appearing in any income return;" a copy of an income return cannot be furnished, except as provided by law, to any one except the person or persons who made the return. Furnishing the maker with a copy of his return is not a divulging of information contained therein to any person, within the meaning of Sections 3167 R. S., as amended. There are numerous provisions in the Statutes constituting the doing or failure to do certain things offenses against the United States, and providing for collecting unpaid taxes by suits in court and for bringing suits to recover taxes and penalties wrongfully collected. These provisions would be of no avail were it held that the returns themselves, or certified copies thereof provided for in Section 882 R. S., could not be used by the Government as evidence in such litigation or in preparation for same. Manifestly Congress did not, when it enacted Section 3167 R. S., intend to defeat prosecutions and suits in court for which it has specifically provided. Income returns filed with the Department are public records of the Department, and public records in the Treasury Department are of right available as evidence in litigation in court unless there is some statute making it unlawful to use them as such.[1] As therefore the use of income returns or copies thereof in connection with litigation in court, where the United States Government is interested in the result, is provided for by law, such returns or copies may be furnished for such use without a violation of the provisions of Section 3167 R. S., as amended.[2]

The following rules and regulations have been prescribed: The original income return of an individual, partnership, corporation, association, joint-stock company, insurance company,

[1] Winn v. Patterson, 9 Pet. 663, 677; Evanston v. Gunn, 99 U. S. 660; 17 Cyc. 306; Williams v. Conger, 125 U. S. 397, 410; Iron Silver Min. Co. v. Campbell, 135 U. S. 286, 298; Oakes v. U. S., 174 U. S. 778; Texas, etc., Ry. Co. v. Swearingen, 196 U. S. 51, 60.

[2] T. D. 2962.

or fiduciary, or a copy thereof may be furnished by the Commissioner to a United States Attorney for use as evidence before a United States grand jury or in litigation in any court, where the United States is interested in the result, or for use in the preparation for such litigation, or to any attorney connected with the Department of Justice designated by the Attorney General to handle such matters if and when the Attorney General states to the Commissioner in writing that such attorney is so designated. When an income return or copy thereof is thus furnished, it must be limited in use to the purpose for which it is furnished and is under no condition to be made public except where publicity necessarily results from such use. In case the original return is necessary, it shall be placed in evidence by the Commissioner or by some other officer or employee of the Internal Revenue Bureau designated by the Commissioner for that purpose, and after it has been placed in evidence it shall be returned to the files in the Office of the Commissioner in Washington. An original return will be furnished only in exceptional cases and then only when it is made to appear that the ends of justice may otherwise be defeated. Neither the original nor a copy of an income return desired for use in litigation in court where the United States Government is not interested in the result and where such use might result in making public the information contained therein will be furnished, except as otherwise provided in the next succeeding paragraph.

A copy of an income return may be furnished by the Commissioner to the person who made the return or to his duly constituted attorney, or if the person is deceased, to his executor or administrator; or if the entity is in the hands of a receiver, trustee in bankrupty, guardian or similar legal custodian, to the receiver, trustee or other similar custodian upon written application for same accompanied by satisfactory evidence that the applicant comes within this provision. "The person who made the return" as herein used refers in the case of an individual return to the individual whose return is desired, and in the case of a return of a corporation, association, joint-stock company, insurance company or fiduciary to the

corporation, association, joint-stock company or fiduciary, a copy of whose return is desired. A corporation may also designate by proper action of its board of directors the officer or individual to whom a copy of a return made by the corporation may be furnished, and upon sufficient evidence of such action and of the identity of the officer or individual, a copy may be furnished to such person. A copy of a partnership income return will be furnished to the partners only in case all the partners join in the request therefor, it matters not what particular partner or officers of the partnership made the return. If the partnership has been dissolved the members surviving may be furnished a copy if all the members surviving join in the request.[3] Ownership certificates are filed as a result of income tax laws for the purpose of being used in connection with income tax returns and are, therefore, to be treated as returns under the regulations governing the furnishing of copies.[4]

[3] T. D. 2962, superseding all former regulations bearing on this subject.

[4] O. 879, Treasury Bulletin 17-19-473.

CHAPTER 35.

ASSESSMENT AND PAYMENT OF THE TAX

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Suit to Restrain Assessment or Collection. It has been held in a recent case that a suit may not be maintained to restrain the collection of taxes where the tax has been assessed against a corporation, which the alleged stockholders claim went out of existence many years before by virtue of the limitation in its charter limiting its corporate existence to 20 years. These stockholders claimed that the assets of the corporation had been taken over by them as partners and they had tendered a partnership return which had been refused by the collector. The contention of the partners was that the prohibition against suits to restrain the collection of taxes operates only against the party assessed, in this case, the corporation. The court, however, held that the prohibition was effective against *all* suits. Unless it appears clear beyond doubt that the property seized or about to be seized is not liable for such assessment, the courts will not interfere.[1]

[1] Markle v. Kirkendall, Dist. Ct. N. D. Pa., decided September 27, 1920.

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PAYMENT OF TAX WHERE PROPERTY TAKEN OVER BY ALIEN PROPERTY CUSTODIAN. Where the property of an alien enemy has been taken over by the Alien Property Custodian and the individual has executed a return but has no funds out of which to pay the amount of tax shown, the return should be filed with the collector but the alien enemy in such case can not be held responsible for failure to pay his income tax, the amount of such tax being a debt due the Government to be considered along with those of other creditors in the final disposition.[1]

[1] O. D. 57, Treasury Bulletin 1-19-78.

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Notice and Demand for Tax. If a return is filed without payment of at least one-fourth of the tax shown by the return to be due, a notice on Form 21 will be sent to the taxpayer covering the correct amount of the first installment, which carries interest from the date on which the return should have been filed up to the date on which payment is made. Such taxpayer will also receive a notice and demand on Form 17 for the second, third and fourth installments and an additional Form 21 covering such matter, if the total is not paid within ten days. Such taxpayers will not be entitled to the privilege of paying the tax in installments.[1]

[1] O. D. 233, Treasury Bulletin 12-19-408.

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Medium of Payment of Tax. A taxpayer who tenders a check, whether certified or uncertified, in payment of taxes, is not released from his obligation until the check is paid. Where such a check is lost in the mails, a collector is not required, as a condition precedent to the issuing of a duplicate check by the taxpayer, to furnish bond indemnifying him against possible loss in connection with the first check.[1]

[1] O. D. 626, Treasury Bulletin 32-20-1125.

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Excess Payment of Tax. Income taxes are assessed for specified periods and may be abated only if illegally or erroneously assessed; that is to say, in ordinary cases if the amount assessed is in excess of the correct amount due from the taxpayer. Manifestly the fact that the taxpayer has overpaid his taxes for a previous year can have no effect upon the amount of tax for which he is liable for a different year. Consequently, prior to the passage of the Revenue Act of 1918, when such conditions existed the only course which the office and the taxpayer could pursue was to collect the present amount in full and permit the taxpayer to file a claim for refund of any amount overpaid. Congress, recognizing the injustice and hardship frequently involved in such an awkward procedure,

provided for crediting the amount of any previous over-payment against the taxes presently due. Such credit, when given, has the force and effect of an order of abatement and wipes out and cancels the assessment *pro tanto.* Such a credit can not be made until the facts have been carefully examined and the validity of the credit approved by the Commissioner. That is not to say, however, that a claim for credit has no effect until approved. The *claim* for credit may have precisely the same effect as a *claim* for abatement; that is, by forbearance of the collector it may suspend collection until it is acted upon by the Commissioner. If approved, credit is then given relieving both the collector and the taxpayer from any further liability. If rejected, interest is to be paid upon the amount suspended from the time it was due. This view of the law is consistent with its language and also with the purpose of relieving the taxpayer from being required to pay into the Treasury amounts, possibly large, at the same time that he is making a *bona fide* claim that other amounts are due him. It does not prevent the collector, if he so desires, from proceeding to collect at once just as he may do in the case of an abatement claim filed, but leaves it optional with him to suspend collection until such time as credit is given relieving both him and the taxpayer.[1] Under the Revised Statutes[2] every collector is charged with the whole amount of taxes, whether contained in lists transmitted to him by the Commissioner or by other collectors, or delivered to him by his predecessor in office, and with the additions thereto, and he is credited only with all payments into the Treasury made as provided by law, and with the amount of taxes contained in the lists transmitted by him to other collectors and by them receipted for, and also with the amount of taxes of such persons as may have absconded or become insolvent prior to the day when the tax ought to have been collected, and with all uncollected taxes transferred by him, or by his deputy acting as collector, to his successor in office, and this is conditioned upon proof, to the satisfaction of the Commissioner

[1] A. R. M. 46, Treasury Bulletin 19-20-924.
[2] R. S., Sec. 3218.

that due diligence was used by him in his endeavor to collect the tax.[3] The filing of a claim for abatement does not necessarily operate as a suspension of the collection of the tax or make it any less the duty of the collector to exercise due diligence to prevent the collection of the tax being jeopardized. He should, if he considers it necessary, collect the tax and leave the taxpayer to his remedy by a claim for refund.[4] There is no provision of law or of the regulations for crediting a collector with any amount of tax which he might be unable to collect by reason of a decrease in the assets of a taxpayer subsequent to the transmission of the list to him, and in no case is he relieved of liability for the amount of the tax in the absence of due diligence in endeavoring to collect it. While there is no provision of law expressly authorizing the collector to require a bond as a condition of suspending the collection of the tax, he is personally charged with the amount of the assessments made against taxpayers in his district and he is required to use due diligence in collecting such taxes. If he fails to exercise due diligence, it is clear that be becomes personally liable for any tax which may be lost through such failure. He may require the tax to be paid and leave the taxpayer to his remedy by a claim for refund, and if he sees fit to suspend the collection of the tax in any case where a final collection may thus be jeopardized, he does it at his own risk. It is within his discretion to protect himself by requiring the taxpayer to execute a bond in the amount of the tax the collection of which is postponed.[5]

The tax imposed on *undistributed* net income of corporations by the Revenue Act of September 8, 1916, as amended, is held to be an income tax, and may be credited against an additional amount of income tax due from the taxpayer.[6]

The provision of the statute respecting claims for credit[7] does not take away the right of a taxpayer to file a claim for refund within two years from the time the cause of action

[3] O. 957, Treasury Bulletin 31-19-652.
[4] Reg. 45, Art. 1032.
[5] O. 957, Treasury Bulletin 31-19-652.
[6] O. 974, Treasury Bulletin 1-20-662.
[7] Revenue Act of 1918, Section 252.

accrues. The five-year limit upon claims for credit does not apply to claims for abatement.[8]

[8] O. 833, Treasury Bulletin 4-19-235.

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PAYMENT WHERE CLAIM FOR CREDIT DENIED. Where a claim for credit is rejected, the tax which is the subject of the claim is chargeable with interest at the rate of one-half of 1% per month from the time the tax was originally due until the claim is decided adversely to the taxpayer; notice of the adverse decision is sent to the collector who must send to the claimant a notice and demand for payment of the assessment; if the tax is paid within the 10-day period following the sending of the notice the 5% penalty is not collectible, and the only interest collectible is that at the rate of one-half of 1% per month from the time the tax was originally due until the date of the Commissioner's decision; if the tax is not paid within the 10-day period, 5% penalty attaches in addition to the above interest and also interest at the rate of 1% per month from the date of the adverse decision by the Commissioner to the date of payment.[1]

[1] Sol. Op. 32, Treasury Bulletin 31-20-1106.

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Footnote 109.

Add:—O. D. 234, Treasury Bulletin 12-19-409; Sol. Op. 60, Treasury Bulletin 36-20-1189.

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Interest on Delinquent Taxes. When it is found upon filing a complete return that the first installment of tax was underestimated at the time of filing a tentative return, interest on the amount by which the tax was underestimated must be collected, irrespective of amount.[1] Where interest is collectible at the rate of 1% per month from the due date interest must be collected for the fractional part of a month where the tax is not paid within 10 days from notice and demand for

[1] O. D. 74, Treasury Bulletin 1-19-106.

payment.[2] No interest is collectible on the difference between the amount of tax paid on the basis of an original return and that shown to be due by an amended return if the understatement in the original return was not due to negligence of the taxpayer.[3] The interest collectible upon the amount of tax due and unpaid ten days after notice and demand by the collector should be computed only upon the amount of tax shown by the return to be due and not upon the tax plus the five per cent. penalty.[4]

[2] O. 884, Treasury Bulletin 13-19-426.

[3] O. D. 691, Treasury Bulletin 42-20-1251.

[4] O. D. 725, Treasury Bulletin 45-20-1298.

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Suits for Collection of Taxes. The fact that an additional assessment of taxes due for 1915 is barred by the statute of limitations has no bearing on a claim for the abatement of 1916 taxes. While the law provides that no sums may be paid from the Treasury to any person indebted to the United States, this provision does not apply to the abatement of taxes erroneously assessed for any year, and the Government should pursue its remedy of a suit for the recovery of any amounts due in 1915, as it is clearly not justified in collecting taxes for 1916 which are not due for that year.[1] The five-year limitation on assessment and suit applies only to taxes due under the Revenue Act of 1918.[2]

[1] A. R. M. 56, Treasury Bulletin 23-20-984.

[2] O. 833, Treasury Bulletin 4-19-235.

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Suits Against Former Residents Now Abroad. Where a former resident of the United States now residing in British Columbia fails to file his return for 1918 and refuses to file a return upon demand of the American consul in that country, the Commissioner should make a return for him from such information as he can obtain, and if no property is found in this country which will satisfy the tax due, but a judgment for the amount of tax due could be satisfied out of property

held by the taxpayer in British Columbia, recourse may be had in the courts of that country for the collection of the tax.[1]

[1] S. 1156, Treasury Bulletin 20-19-516. It is probable that the United States would at least have to waive any penalties if it attempted to collect this tax in the courts of British Columbia, since the courts of no country execute the penal laws of another—even penalties for any violation of statutes for the protection of its revenues. It seems somewhat doubtful whether the courts of British Columbia would entertain an action for the tax itself (Wisconsin v. Pelican Ins. Co., 127 U. S. 265; King of Spain v. Oliver, 2 Wash. 429; Whart. Confl. L. Paragraph 833; Westlake Internat. L. 1st Ed. Paragraph 388; Piggott. Foreign Judg. 209, 210).

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Taxes Collectible by Distraint. The addition of $5 to the tax where it becomes necessary for a collector to cause a warrant of distraint to be served is applicable only to income, war-profits and excess-profits taxes imposed for 1918 and subsequent years by the Revenue Act of 1918.[1] The charge of $5 is to be added as a part of the tax when a warrant of distraint is served irrespective of the fact that the delinquent may be the estate of an insane, deceased, or insolvent person.[2] The charge of $5 required to be added to the tax in cases where it is necessary to use a warrant of distraint, is collectible not upon the issuance but upon the serving of such warrant. If the warrant is placed in the hands of the taxpayer or is read to him personally, it is considered as having been served whether payment of the tax is made at once or is deferred so that it becomes necessary to seize property of the taxpayer.[3]

[1] T. D. 3042, Treasury Bulletin 29-20-1080; O. D. 304, Treasury Bulletin 24-19-575; O. D. 652, Treasury Bulletin 35-20-1175.

[2] O. D. 270, Treasury Bulletin 18-19-486.

[3] O. D. 442, Treasury Bulletin 14-20-837.

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Compromise of Tax. It is well established that the Commissioner has no power to compromise taxes legally due from a solvent taxpayer.[1]

[1] S. 1371, Treasury Bulletin 24-20-1006; see R. S., Sec. 3229; S. 1317, Treasury Bulletin 24-20-1006.

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PERSONS LEAVING COUNTRY. An *alien* desiring to depart from the United States is required to submit to the proper official a certificate signed either by the collector for the district in which he last resided, or for the district in which the port of embarkation is located, stating that the collector has satisfied himself that the alien has complied with all tax obligations with respect to income accruing up to the end of the month just preceding the date of the issuance of the certificate.[1] *Resident aliens* desiring to leave the United States temporarily will be required to show that all income tax obligations for the taxable year and years prior to the date of departure have been satisfied, and that provision has been made for the payment of subsequent installments as they become due; also, that arrangements have been made for filing of returns and the payment of tax for the succeeding year, should their absence extend beyond the time for filing such returns and payment of such tax.[2] An *American citizen* applying for a sailing permit will also be required to satisfy the internal revenue agent in charge that he has paid all installments of income tax due up to the date of departure and has made arrangements for the payment of future installments as they become due.[3]

Consular receipts showing payment of United States income taxes through a United States consulate by American citizens residing abroad will be accepted by revenue agents at ports of embarkation as evidence of satisfaction of income tax obligations in the case of departure of such citizens temporarily in this country.[4] For the purpose of the Revenue Act of 1918 the Virgin Islands are foreign territory and a trip to these

[1] O. D. 131, Treasury Bulletin 3-19-205.

[2] O. D. 331, Treasury Bulletin 28-19-617.

[3] M. 2195, Treasury Bulletin 13-19-429. In order to obtain income tax clearance, American citizens planning to leave the United States are required to present their certificates of compliance or receipts showing payment of income tax, at the office of the internal revenue agent in charge at the port of embarkation, rather than to the internal revenue agent at the pier. (O. D. 666, Treasury Bulletin 38-20-1207.)

[4] O. D. 500, Treasury Bulletin 19-20-923.

islands is a departure from the United States. Citizens of the Virgin Islands residing in the United States and planning to go to the islands are treated in the same manner as citizens of the United States in the matter of satisfying income tax obligations before departing from this country.[5] In computing the tax liability of any person whose taxable period is terminated in accordance with the above rulings, the taxpayer is entitled to the same personal exemption or credit for dependents as he would have been had the return been prepared for the full taxable year.[6] The above rules with respect to departing aliens do not apply to representatives of foreign countries bearing diplomatic passports.[7] If any tax has been withheld from the wages or other income of an alien, credit therefor will be given to the alien in computing any balance of tax due the United States Government. An alien appearing before the collector will be questioned as to his earnings for 1916, 1917, 1918, and 1919.[8] If the name of an alien leaving the country does not appear on any Form 1042 filed by his employer for the years 1916, 1917, 1918 and 1919, the collector may for the purpose of determining the alien's tax liability, require the employer to furnish statements of the alien's earnings for the years in question.[9] An alien who is a resident during the year 1918 and decides in 1919 to return to his native country will be classified as a non-resident alien for the taxable period of 1919.[10]

Internal revenue agents are authorized to board vessels of United States registry for the purpose of ascertaining whether the income tax liability of United States sailors on board such vessels has been satisfied. In a case where a United States sailor refuses to pay any income tax due, the Passport Control Division of the State Department advises that the revenue

[5] O. D. 332, Treasury Bulletin 28-19-618.
[6] M. 2195, Treasury Bulletin 13-19-429.
[7] O. D. 271, Treasury Bulletin 18-19-487.
[8] M. 2195, Treasury Bulletin 13-19-429.
[9] O. D. 385, Treasury Bulletin 4-20-709; Revised Statutes 3173.
[10] M. 2195, Treasury Bulletin 13-19-429.

agent is justified in taking up and withholding the sailor's passport until the tax due is paid.[11]

If a citizen about to leave the United States wilfully refuses to pay a tax properly due, he may be arrested and detained for the purpose of facing prosecution criminally for a violation of the Revenue Act of 1918. Furthermore, the district courts of the United States, at the instance of the United States, are invested with jurisdiction to make and issue writs and orders of injunction and *ne exeat republica* and such orders and process as may be necessary or appropriate for the enforcement of the provisions of the Revenue Act of 1918. With respect to these provisions a citizen departing is in no different position from a citizen continuing in the United States—the act being enforceable alike against taxpayers continuing in the United States and taxpayers departing from the United States.[12]

[11] O. D. 566, Treasury Bulletin 27-20-1035.

[12] O. D. 168, Treasury Bulletin 6-19-282; see also Revenue Act of 1918, Section 253; Section 1318.

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Priority of Federal Taxes. The government has no priority in the matter of collecting taxes from a bankrupt over the administration expenses of the bankruptcy proceedings, its priority in this respect being limited to creditors of the bankrupt.[1]

[1] Smietanka v. Zibell, U. S. Circuit Court of Appeals, Seventh Circuit, January, 1920; T. D. 3000, Treasury Bulletin 15-20-857. See also Guaranty Title & Trust Co. v. Title Guaranty & Surety Co., 224 U. S. 152.

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PROCEDURE ON APPEAL TO COMMITTEE ON APPEALS AND REVIEW. When an appeal is taken from a ruling of the Income Tax Unit to the Committee on Appeals and Review or a question is certified to that Committee at the request of the taxpayer and an oral presentation is desired, the record must immediately be examined to ascertain as to whether there is a question of law involved. If it is found that a question of

law is involved, the Solicitor must be notified and he will thereupon designate one member of the Solicitor's office to sit with the Committee and himself for the purpose of hearing the appeal, or if the Solicitor finds it inconvenient to sit with the Committee he may designate two members of his office to do so. At the hearing before the Committee the taxpayer or his attorney or representative will be expected to make his full oral argument on the law as well as the facts, and this presentation will be the only oral presentation except in unusual circumstances, or unless a further argument of the facts or the law is deemed desirable by either the Chairman of the Committee or the Solicitor. The attorney or attorneys so designated by the Solicitor for the hearing will be expected, in conjunction with the Solicitor and the Conference Committee in the Solicitor's office, if the Solicitor so desires, to consider the legal aspects of the case, and the Solicitor's recommendation in the form of an opinion or memorandum will then be made to the Chairman of the Committee, and thereupon the Committee's findings will be prepared and submitted to the Commissioner for his approval. In any case of appeal there must be filed with the Committee, either at the time of filing the appeal or on or before the date set for oral presentation, if oral argument is desired, a succinct written statement of the essential facts which the taxpayer desires to have considered in connection with his appeal, duly sworn to. If the taxpayer, his attorney, or representative does not wish an oral argument, his argument may be made in the form of a written statement or brief which should be filed at the time the appeal is submitted to the Committee. If an oral presentation is to be made, the taxpayer, his attorney, or representative may in addition thereto file such brief or briefs as he may desire. These briefs, not less than three copies of which should be furnished, may be either printed or typewritten, and where practicable should be filed not less than three days before the appeal is to be heard. Additional briefs may be filed at the time of or subsequent to the hearing within the time prescribed for the particular case by the Committee.[1]

[1] O. D. 709, Treasury Bulletin 43-20-1272.

CHAPTER 36.

PENALTIES AND COMPROMISES

[Page 552.]

Failure to File Return. Penalties for delinquencies in filing supplemental tax returns for fiscal years ending in 1918 should be imposed upon corporations as for delinquencies in filing tax returns for the calendar year 1918, subject to such modifications in cases of compromises as may seem to be warranted by the circumstances.[1]

[1] T. B. R. 31, Treasury Bulletin 7-19-306.

[Page 553.]

EXCEPTION. Where the attendant and surrounding circumstances have a tendency to cast doubt and suspicion upon a taxpayer, a plea of mere ignorance is not sufficient to constitute a reasonable cause for failure to make and file a return within time.[1]

[1] O. 818, Treasury Bulletin 3-19-204.

[Page 553.]

Footnote 8.
Add:—S. 1359, Treasury Bulletin 13-20-817.

[Page 554.]

False Returns. The term "understatement" has particular reference to the understatement of the amount of the tax in the return. This is true whether such understatement resulted from the false or fraudulent computation of the tax or from false or fraudulent misstatements or omissions of items of income or misstatements of items of deduction or from other false or fraudulent entries or omissions.[1] "Negligence on the part of the taxpayer, but without intent to defraud," is presumed to exist in every case in which a deduction has been

[1] O. 1008, Treasury Bulletin 10-20-782.

made or income has been omitted in direct conflict with the specific provisions of the law and regulations, but is not presumed to exist if the understatement may be ascribed to an error of judgment as to some matter not so concluded.[2] In cases where delinquent returns are filed and the total tax is paid at the time of filing, the penalty of 5% and interest at the rate of 1% per month does not attach.[3] Where an amended return showing additional tax liability has been filed, no interest on the additional tax will be collected unless 10 days after notice and demand by the collector the amount of the additional tax assessed has not been paid, provided there appears to have been no neglect or intent to defraud upon the part of the taxpayer.[4] In cases where an addition of 25% or 50% is made to the tax on account of delinquency or fraud, and the taxpayer fails to pay the tax within 10 days after notice and demand from the collector, the 5% penalty and interest attach not only to the amount of tax shown to be due by the return, but also to the 25% or 50% addition to the tax.[5]

[2] A. R. M. 23, Treasury Bulletin 7-20-746.
[3] O. D. 313, Treasury Bulletin 25-19-588.
[4] O. D. 366, Treasury Bulletin 2-20-678.
[5] O. D. 441, Treasury Bulletin 14-20-836.

[Page 554.]

Footnote 12.
Add:—O. 1008, Treasury Bulletin 10-20-782.

[Page 555.]

Fraudulent Returns. In a case in which a taxpayer in good faith and *without any fault* on his part failed to report certain items of income in his return and also *negligently* failed to report other items of income, and also *fraudulently* and with intent to evade the tax failed to report other items of income, it has been ruled that the return is to be dealt with as a whole; that no part of the deficiency or understatement is free from penalty if a part of the return is tainted with fraud or negligence; that the penalty of 5% of the whole amount of the deficiency does not attach because a greater penalty is provided, the statute making no provision for dividing up the

deficiency and applying to various parts of it different penalties; that the penalty of 50% will be applied to the entire amount of deficiency or understatement which is tainted with fraud and not to simply a part thereof.[1] A taxpayer who filed a return of income which did not include profit on the sale of certain corporate stock and in reply to an inquiry by an examining officer stated that he had not made any money on outside investments during the year, but in reply to a direct inquiry in regard to the sale of the stock, based on confidential information, admitted the sale, but made no explanation of his failure to include the profit on the sale in his return for the taxable year, is held to have filed a false and fraudulent return for the purpose of evading taxation and the 100% additional tax should be assessed.[2]

[1] O. 1028, Treasury Bulletin 18-29-103.

[2] S. 926, Treasury Bulletin 1-19-105. This ruling was made under the 1913 Law.

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Returns of Withholding Agents. The *ad valorem* penalties for fraudulent returns should be assessed against withholding agents under the income-tax provisions of the law. The *ad valorem* penalties for delinquent returns should be assessed against withholding agents, except that if the tax required to be withheld is paid by the recipient of the income, no such penalty should be collected from the withholding agent unless his delinquency was fraudulent and for the purpose of evading payment.[1]

[1] S. 1334, Treasury Bulletin 8-20-758.

[Page 556.]

Attempts to Evade the Tax. The giving of instructions or advice with the purpose and intent of inducing persons liable to make income returns or pay income tax to refrain from making such returns or paying such tax is an attempt to defeat the tax within the meaning of the statute, and those giving such instructions or advice are amenable thereto.[1]

[1] S. 931, Treasury Bulletin 1-19-108.

[Page 556.]

Delay in Payment of Tax. It has been held under the 1916 Law that where an income tax was assessed against a person who failed to make payment when it became due, and the collector thereupon gave notice and made demand for payment, and prior to the expiration of 10 days after such notice and demand the Alien Property Custodian, under the provisions of the Trading-with-the-Enemy Act of October 6, 1917, took over all the property of such person, thereby rendering it impossible for him to make payment within the time required, the 5% penalty and interest at the rate of 1% per month do not attach.[1] The general extension of time for filing returns granted to non-resident alien individuals or their proper representatives in the United States for such period as may be necessary, not exceeding 90 days after proclamation by the President of the end of the war with Germany,[2] does not affect the liability to the 5% penalty of such individuals who filed returns before the expiration of this extension period, if they failed to pay the tax due on such return within the prescribed time after it was filed.[3]

Where a taxpayer filed an amended return showing a lesser amount of tax due than was shown in his original return, but did not file a claim for abatement of the excess tax shown in his original return until after 10 days following notice and demand from the collector for payment of the tax due, assuming that the amended return was a substitute for the original return, the claim subsequently being rejected, it was held that the 5% penalty and the 1% interest must be asserted for failure to pay the tax within 10 days after notice and demand. "Reasonable cause" is associated by the Act only with the 25% penalty in case of failure to file return within the time prescribed, and will not relieve a taxpayer from penalties incident to failure to pay any tax due within 10 days after notice and demand for payment.[4]

[1] O. 1026, Treasury Bulletin 17-20-876.
[2] Reg. 45, Art. 445, as amended by T. D. 2844.
[3] O. D. 608, Treasury Bulletin 30-20-1095.
[4] O. D. 706, Treasury Bulletin 43-20-1268.

[Page 557.]

Statute of Limitations. There is sufficient valid consideration to support the acceptance of an offer in compromise of a specific penalty made by the taxpayer, even though the action thereon is barred by the statute of limitations.[1] Offers in compromise rest upon the same legal principles as ordinary contracts.[2] While there are cases holding that the acceptance of an offer relates back to the date of the offer, the general rule in ordinary cases is that the date of a contract is the date of its acceptance.[3] Therefore, if a claim of the Government for penalties is without any foundation at all, either in law or in equity, there is not sufficient consideration for compromise. If, on the other hand, the Government does surrender its claim and the claim has some foundation, either in law or in equity, there is sufficient consideration. Since the statute of limitations relating to penalties does not extinguish the cause of action but merely bars the remedy of the Government and the statute of limitations is not a question of jurisdiction but of personal defense, an offer in compromise may legally be accepted after the expiration of the period of limitation.[4] Consequently, when an offer in compromise is made before the expiration of the period and is not withdrawn it has been ruled that the failure to withdraw can be considered as a renewal of the offer to meet changed conditions and may be properly and legally accepted.[5]

Where an income tax return under the Revenue Act of 1916, or an income or excess-profits tax return under the Revenue Act of 1917, has been found to be false and fraudulent and the additional tax has been assessed and paid at a time when the grounds for asserting the 100% fraud penalty were fully known to the Treasury Department, no fraud penalty may be thereafter assessed; where under such circumstances the addi-

[1] Sol. Op. 7, Treasury Bulletin 25-20-1019.

[2] Boughton v. U. S., 12 Ct. Cl. 330.

[3] Williston on Contracts, Vol. I, Sections 96-97.

[4] See Taylor v. Weeks, 129 Mich. 233, 88 N. W. 466; Burriss v. Starr, 165 N. C. 657, 81 S. E. 929; Herrington v. Davitt, 220 N. Y. 162, 115 N. E. 476, 1 A. L. R. 1700.

[5] Sol. Op. 7, Treasury Bulletin 25-20-1019.

tional tax has been assessed but not paid or paid but not assessed, the fraud penalty may still be assessed. The rule under the Revenue Act of 1918, however, is different. The 50% fraud penalty may be subsequently assessed although the additional tax has been both assessed and paid after the discovery of the fraud. Under all three of these Acts, if the additional tax has been assessed or paid, or assessed and paid prior to discovery of the fraud, the penalty may be assessed at any time after the discovery and within the statutory period for assessment of taxes.[6]

Unless tax liability is discovered within three years from the time the returns were due under the 1809, the 1913 and the 1916 Laws, the Commissioner has no authority to assess the 100% *ad valorem* penalty for false or fraudulent returns in the absence of a waiver of the rights as to the limitation of assessment of such penalties.[7]

[6] Sol. Op. 52, Treasury Bulletin 36-20-1188.
[7] Sol. Op. 60, Treasury Bulletin 36-20-1189.

[Page 557.]

Footnote 30.
Add:—O. 907, Treasury Bulletin 18-19-489.

[Page 558.]

Footnote 31.
Add:—Where delinquent individual returns for the taxable year 1914 have been filed after the expiration of the three-year period of limitation, specific and *ad valorem* penalties will not be asserted. If the taxpayers signed the delinquent returns it will not be necessary to secure waivers for the purpose of assessing the taxes. (O. D. 530, Treasury Bulletin 22-20-977.)

[Page 559.]

AD VALOREM PENALTIES. Where the Bureau has determined that no penalty is due and has rejected an offer in compromise, a notice of "special allowance" is sent to the collector, who then instructs the taxpayer to file claim for refund on Form 627.[1]

[1] O. D. 539, Treasury Bulletin 23-20-990.

[Page 559.]

Footnote 39.

Add.—O. 907, Treasury Bulletin 18-19-489.

[Page 560.]

OFFERS IN COMPROMISE. A taxpayer having filed his return and paid the first installment of tax is aware of his liability to pay the balance of the tax on the respective due dates, and failure to receive notice and demand for the payment of the later installments by reason of his absence from this country does not constitute a sufficient cause for waiving the penalty and interest on any installment of the tax not paid when due.[1]

[1] O. D. 408, Treasury Bulletin 9-20-775.

CHAPTER 37.

ABATEMENT, REFUND AND RECOVERY OF TAXES

[Page 565.]

EFFECT OF REJECTION OF CLAIM FOR ABATEMENT. In a recent case the Supreme Court has decided that a claim for refund is necessary as a prerequisite to recovery in the courts, even though a claim in abatement has been rejected.[1]

[1] Rock Island, etc., Rd. Co. v. U. S., decided by the United States Supreme Court on November 22, 1920, overruling Loomis v. Wattles, 266 Fed. 876, and cases cited in 1920 edition, and affirming principle of Hastings v. Herold, 184 Fed. 759. The Court made the interesting remark in the Rock Island case that "men must turn square corners when they deal with the Government."

[Page 565.]

PROCEDURE FOR CLAIMING ABATEMENT. A claim for abatement of an apparently excessive tax assessed on the basis of a tentative return will not be considered prior to the filing by the taxpayer of a completed return.[1] Where property of a corporation is in the hands of a receiver who files a claim for abatement of an additional assessment of income and profits taxes for 1917, no bond will be required as security for the payment of such taxes.[2]

[1] O. D. 634, Treasury Bulletin 33-20-1139.

[2] O. D. 733, Treasury Bulletin 47-20-1316. The Government, however, has the right under R. S. 3466, to receive payment of these taxes from a receiver in preference to creditors.

[Page 566.]

PAYMENT WHERE CLAIM FOR ABATEMENT DENIED. Where a claim for abatement or a claim for credit is rejected, the tax which is the subject of the claim is chargeable with interest at the rate of one-half of 1% per month from the time the tax was originally due until the claim is decided adversely to the taxpayer; notice of the adverse decision is sent to the collector

who must send to the claimant a notice and demand for payment of the assessment; if the tax is paid within the 10-day period following the sending of the notice the 5% penalty is not collectible, and the only interest collectible is that at the rate of one-half of 1% per month from the time the tax was originally due until the date of the Commissioner's decision; if the tax is not paid within the 10-day period, the 5% penalty attaches in addition to the above interest and also interest at the rate of 1% per month from the date of the adverse decision by the Commissioner to the date of payment.[1]

[1] Sol. Op. 32, Treasury Bulletin 31-20-1106.

[Page 567.]

STATUTE OF LIMITATIONS. Amended returns filed with the Commissioner do not constitute the beginning of new proceedings which so supersede the original returns as to release the taxpayer from his obligation to observe the statutory requirements for the review of such original returns.[1]

[1] Maryland Casualty Co. v. U. S., 251 U. S. 342. The doctrine of Cheatham v. U. S., 929 U. S. 85, is inapplicable to this situation.

[Page 571.]

Suits to Recover Taxes. Where an illegal tax is paid, the fact that it was not paid within the time allowed by law will not prevent the taxpayer from recovering a penalty paid by him for the nonpayment of the illegal tax, for, if the tax was illegal, it was never due, and therefore the penalty was as much unauthorized as the tax itself.[1]

[1] Camp Bird Ltd. v. Howbert, 262 Fed. 114.

[Page 572.]

Footnote 50.

Add:—Maryland Casualty Co. v. U. S., 251 U. S. 342.

[Page 573.]

Footnote 58.

The case of New York Life Ins. Co. v. Anderson, 257 Fed. 576, has been reversed on another point (see 263 Fed. 527). For a history of the equitable action of assumpsit for money had and received see McKyring

v. Bull, 16 N. Y. 297, and Cary v. Curtis, 3 How. 236 (dissenting opinion by Story, J.). In the latter case the dissenting opinion of Story, J., was confirmed as a correct expression of the Congressional intent by the explanatory act of Congress of February 26, 1845. (See Arnson v. Murphy, 109 U. S. 238.) The case of International Paper Co. v. Burrill, 260 Fed. 664, which permits an action for recovery of a Massachusetts tax illegally collected against the collector personally, contains a thorough discussion of the subject of actions against collectors and lays down the rule that a void act gives no protection to the collector from such recovery, that the collector is not discharged from responsibility by the fact that he deposits the illegal tax with the treasury of the taxing authority, that the taxing authority may not equip officials with apparent power under unconstitutional statutes to obtain money from taxpayers and to retain such money in its treasury unless the legislature of the taxing power should "mercifully" otherwise decided.

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SUITS AGAINST COLLECTORS. Sums due the United States are a valid offset as against amounts found due taxpayers in suits against collectors, though included therein are items which the Commissioner did not claim to be due the United States when considering the return for assessment purposes.[1]

[1] T. D. 2882, Treasury Bulletin 9-19-347.

[Page 575.]

Footnote 66.

Add:—N. Y. Life Ins. Co. v. Anderson, 263 Fed. 527.

CHAPTER 38.

EXAMINATION OF TAXPAYERS' BOOKS

[Page 578.]

Examination of Books. A taxpayer is entitled to satisfy himself in a reasonable manner of the official character and authority of any person making request to examine books or accounts of his bank as an official of the Internal Revenue Bureau.[1]

[1] O. D. 609, Treasury Bulletin 30-20-1096.

CHAPTER 39.

INFORMATION AT THE SOURCE

[Page 587.]

SALARIES, WAGES OR COMPENSATION. Fees paid by a corporation for professional services should be included in a return of information when the amount paid to any individual or partnership during the calendar year equals or exceeds $1,000.[1] In executing Form 1099 an employer who is required to withhold the tax from an employee under a State income tax law should report the amount of the salary paid to the employee plus the amount of tax withheld. The employee should report the same amount in his return.[2]

[1] O. D. 416, Treasury Bulletin 12-20-800.

[2] O. D. 401, Treasury Bulletin 6-20-733.

[Page 588.]

PAYMENTS WHICH NEED NOT BE REPORTED. Where a lease provides for a payment of rental in crop shares, the landlord and tenant sharing the expenses proportionately, such payments are not fixed or determinable and need not be reported.[1]

Where an individual, a resident of this country, is entitled to the interest accruing on some German war loan securities which are held for him by a German bank which institution has requested a domestic bank to transmit the amount to the individual, by drawing a check or draft upon the foreign bank, it is held that an ownership certificate is not required until the foreign item is actually collected, either by the cashing or the depositing of the check and no responsibility with respect to requiring an ownership certificate attaches to the domestic banking institution in connection with this transaction unless the individual presents the foreign item to it for collection. When the foreign item is collected the amount should be reported on ownership certificate, Form 1001-A, revised, in the

[1] O. D. 115, Treasury Bulletin 2-19-172.

equivalent of United States money values, according to the rate of exchange in effect at the time collection is made. The check or draft drawn by the domestic banking institution on the foreign banking institution should bear a notation as to what the payment represents, in order that the first bank making payment of such amount may be enabled to identify the check as a foreign item.[2]

[2] O. D. 641, Treasury Bulletin 34-20-1150.

[Page 590.]

OWNERSHIP CERTIFICATES FOR FOREIGN ITEMS. When bonds of foreign countries, or bonds or stocks of nonresident foreign corporations, are owned by citizens or residents of the United States, individual or fiduciary, by domestic or resident foreign corporations, or partnerships, or by personal-service corporations, ownership certificate Form 1001-A (revised) should be executed by the actual owner or by his duly authorized agent when presenting the item for collection, whether such item is a dividend or an interest payment, except in the case of a foreign country or a foreign corporation having a fiscal agent or a paying agent in this country and issuing bonds which contain a tax-free covenant clause. In such a case the fiscal agent or paying agent is required to withhold the normal tax of 2% from the interest on such bonds and ownership certificate Form 1000 (revised) modified to show the name and address of the fiscal agent or the paying agent, should be used, unless the owner (if so entitled) desires to claim exemption, in which case Form 1001-A (revised) should be filed. When such foreign bonds or stocks are owned by nonresident alien individuals, corporations, or partnerships, ownership certificate Form 1001-A (revised) should be used on behalf of such owners by any responsible bank or banker, either foreign or domestic, having knowledge of such ownership. In such a case the bank or banker need not fill in the names of the owners.[1]

Nonresident alien individuals, partnerships, and corpora-

[1] Reg. 45, Art. 1078, as amended by T. D. 3031, Treasury Bulletin 25-20-1020.

tions should file Form 1001-A properly modified, in connection with interest coupons on bonds of a corporation organized in the United States but which transacts no business in the United States and owns no property therein.[2]

In cases where a foreign corporation is the registered owner of stock of a domestic corporation and the actual owner is a nonresident alien individual or partnership, disclosure of actual ownership should be made on Form 1087 (revised) in order that a domestic corporation required to render a return of information as to dividends may have at its disposal information as to actual ownership of the stock. The foreign corporation as the registered holder is not, however, required to render any return or withhold any tax from income paid to the actual owner of the stock, nor is there any provision under the Revenue Act of 1918, whereby any withholding of tax at the source is required by the debtor corporation with respect to such income whether actually owned by the registered owner or by a third party.[3]

[2] O. D. 354, Treasury Bulletin 31-19-653.

[3] O. D. 162, Treasury Bulletin 5-19-263.

[Page 591.]

FOREIGN ITEMS PRESENTED FOR COLLECTION UNACCOMPANIED BY OWNERSHIP CERTIFICATES. If the foreign item is an interest coupon detached from bonds containing a tax free covenant clause, issued by a foreign country or corporation having a paying agent in the United States an affidavit and ownership certificate, Form 1000 (revised) should be furnished.[1]

In the case of other foreign items which are received unaccompanied by an ownership certificate and the owner is unknown, an affidavit is required of the payee, showing the name and address of the payee, the name and address of the debtor organization, the date of the dividend check or the maturity of the interest coupon, the name and address of the person from whom the dividend check or interest coupon was received, and a statement that the owner of the securities is unknown

[1] See Reg. 45, Art. 368.

to the payee. The first bank receiving such foreign item should prepare a certificate of ownership, Form 1001-A (revised) crossing out the word "owner" and substituting therefore the word "payee". The first bank should stamp or write across the face of the certificate "affidavit furnished," adding the name of the bank. Thereupon the affidavit and certificate should be forwarded to the Commissioner.[2]

[2] Reg. 45, Art. 1078 (a), added by T. D. 3030, Treasury Bulletin 25-20-1021; O. D. 377, Treasury Bulletin 3-20-694. The affidavit and certificate are forwarded as provided in Article 1079 of Regulations 45.

[Page 591.]

RETURN OF INFORMATION AS TO FOREIGN ITEMS. The procedure set forth in this paragraph of the 1920 edition with respect to the return of information regarding the collection of foreign interest items is applicable as well to the interest on foreign *registered* bonds.[1]

[1] O. D. 674, Treasury Bulletin 39-20-1216.

[Page 592.]

Footnote 23.

No bond is required in connection with the issuance of Form 1010, license to collect foreign items, if the collector is satisfied as to the responsibility of the applicant for the license. (O. D. 653, Treasury Bulletin 35-20-1176.)

[Page 593.]

Footnote 27.

Add:—The Revenue Act of 1918 does not require a return of information with respect to the income of nonresident aliens which is not fixed or determinable. If a withholding agent files Forms 1098, revised, and 1042, revised, in connection with payments of annual or periodical income to nonresident alien individuals, it will not be necessary to file Form 1099. (O. D. 673, Treasury Bulletin 39-20-1215.)

[Page 595.]

Affiliated Corporations. Affiliated corporations are required to make a consolidated return of net income and invested capital, but they will not be permitted to file a consolidated return of information at the source. Each corporation must file a separate return of information.[1]

[1] O. D. 469, Treasury Bulletin 16-20-268.

[Page 595.]

Department of Municipal Government. A department of a municipal government is required to file a return of information, excluding, however, payments made as salary or wages to officials or employees of the State or political subdivisions thereof, and payments of interest on obligations of a State or political subdivision thereof.[1]

[1] O. D. 470, Treasury Bulletin 16-20-869.

CHAPTER 40.

COLLECTION OF THE TAX AT THE SOURCE

[Page 597.]

Definition. A foreign corporation not engaged in trade or business within the United States, which has a fiscal agent in the United States, is not a resident corporation.[1]

[1] O. D. 144, Treasury Bulletin 4-19-225.

[Page 597.]

Footnote 7a.

Add:—O. D. 339, Treasury Bulletin 29-19-628.

[Page 598.]

Appointment of Withholding Agent. A debtor corporation which has appointed a withholding agent, should file with the collector for the district in which the debtor corporation is located notice of such appointment, giving the name and address of the withholding agent. Only one copy is required and no special form is prescribed.[1]

[1] O. D. 207, Treasury Bulletin 10-19-359; Treasury Bulletin "B", page 31.

[Page 598.]

Fixed or Determinable Annual or Periodical Income. The share of profits of a foreign corporation under an arrangement with a domestic corporation whereby the latter purchased goods from the former at a minimum price for resale in the United States, the domestic corporation receiving a commission in the event of resale in excess of the minimum price, and the balance of the excess (after the deduction of certain expenses) being divided between the two corporations, represents income from sources within the United States, but is not subject to withholding since it is not fixed or determinable income.[1] Where a corporation engaged in business as ship

[1] O. D. 384, Treasury Bulletin 4-20-708.

chandlers in accordance with the well recognized practice of the trade, in order to secure the trade of certain ships' captains sells bills of goods and supplies to a ship's captain at a marked price, the invoice showing goods sold in this amount, but accepts as payment in full from the ship's captain a smaller amount, the difference between the two amounts being in the nature of discount or commissions and operating to reduce the price of the goods and supplies sold, it is held that the corporation is not the payor of fixed or determinable annual or periodical income.[2]

[2] A. R. R. 265, Treasury Bulletin 40-20-1225.

[Page 598.]

Footnote 12.

Add.—Treasury Department Bulletin "B", page 31.

[Page 600.]

INTEREST. Profits derived by a non-resident foreign corporation from the purchase and sale through an agent in this country of bank acceptances at a certain rate of discount are based on interest as accrued and such interest, being fixed or determinable income, is subject to withholding.[1]

A domestic corporation owning a majority of the stock of a foreign corporation should withhold the tax on interest credited to the latter.[2]

Interest on call loans made by a domestic bank for the account of a foreign bank is subject to withholding. While the actual amount of interest may vary daily on account of the fluctuation of the principal, the rate of interest is fixed and the amount of interest is therefore determinable. The total amount of interest credited to the account of the foreign bank during the calendar year is the amount subject to withholding.[3]

[1] O. D. 221, Treasury Bulletin 11-19-387.

[2] O. D. 330, Treasury Bulletin 28-19-616.

[3] O. D. 549, Treasury Bulletin 24-20-1007.

[Page 602.]

RACE TRACK WINNINGS. Winnings of horses at a race track credited by the racing association to a nonresident alien

owner and trainer of the horses winning such amounts are not fixed or determinable annual or periodical income and no withholding by the racing association is necessary.[1]

[1] S. 975, Treasury Bulletin 2-19-157.

[Page 602.]

EQUIPMENT TRUST CERTIFICATES. Where a trust company, a domestic corporation, entered into an agreement with a foreign railway company by which the trust company leased to the railway company certain railroad equipment and rolling stock for a term of years, the privilege being reserved to the lessee at the expiration of the lease and upon meeting all obligations therein stipulated, to purchase the property for a nominal consideration, the trust company at the same time entering into an agreement with another domestic trust company under which the first trust company was constituted trustee for the subscribers obtained by the second trust company to a fund to be used for the purchase of the railroad equipment and rolling stock which was the subject of the rental agreement, the agreement further providing that the first trust company should issue to the subscribers of the fund equipment trust certificates with semi-annual dividend warrants attached payable only out of rentals paid to the trustee under the lease agreement, it has been held hat the obligation to pay the principal of the certificates and the semi-annual dividends thereon is that of the first trust company and that the income derived from such certificates should, therefore, be treated as a domestic item. Although the term "dividends" is used, such payments are in reality interest or compensation at a fixed rate payable at a fixed date for money loaned and are not a dividend declared upon the net earnings of the first trust company. Neither the lease, the equipment trust nor the certificates contain a tax-free covenant clause. The dividends should be reported on ownership certificates, Form 1000, revised, or Form 1001, revised, depending upon whether or not the owners of the certificates are non-resident aliens.[1]

[1] O. D. 689, Treasury Bulletin 42-20-1249.

[Page 602.]

Bond Interest. In a recent case a company was trustee for the debenture holders of a banking corporation under an agreement whereby the trustee was to hold the collateral deposited to secure payment of the principal of the bonds and interest. The bonds did not contain a tax-free covenant clause. Since the insolvency of the banking corporation in 1914 the trustee was engaged in liquidating the collateral and applying the proceeds in payment of the debentures. The principal of the collateral having proved insufficient to cover the principal of the debentures, a part of the interest collected on the collateral was applied in payment of the debenture principal and the question was presented whether, with respect to payments to non-resident alien bondholders, the tax should be withheld and paid on the collateral interest accepted in part satisfaction of the debt, and whether the trustee should withhold and pay a tax of 8% on the amounts paid during 1920 as arrears of interest. It was held that no tax was due on the interest from the collateral security applied in satisfaction of the debenture principal, but the trustee was required to withhold and pay a tax of 8% on the amounts paid in 1920 to non-resident aliens on account of arrears of interest.[1]

[1] O. D. 624, Treasury Bulletin 32-20-1120.

[Page 602.]

Footnote 31.
Add:—T. B. R. 29, Treasury Bulletin 7-19-303.

[Page 602.]

Footnote 33.
See O. D. 628, Treasury Bulletin 33-20-1129.

[Page 603.]

Footnote 35.
Add:—O. D. 167, Treasury Bulletin 6-19-277.

[Page 604.]

INTEREST UPON BONDS CONTAINING A TAX-FREE COVENANT. The provisions of the statute[1] are not applicable to bonds

[1] Revenue Act of 1918, section 221 (b).

containing a tax-free covenant clause issued by a partnership. No tax is required to be withheld from the interest on bonds issued by an obligor other than a corporation unless the interest is paid to non-resident alien individuals or non-resident foreign corporations in which case the normal tax of 8% or 10%, respectively, is required to be withheld.[2] Where a domestic corporation issues tax-free bonds which contain an agreement to pay to the bearer at maturity of the coupons the sum of 5 pounds sterling at the London office of a domestic bank, or $24.34 in gold coin of the United States at a bank in the foreign country in which the debtor corporation is engaged in business, and a citizen of Great Britain elects to accept payment in pounds sterling and receives the equivalent of $19.75 according to the rate of exchange upon the date he receives payment in London, it has been ruled that the debtor corporation is required to withhold the normal tax of 2% on the amount of $19.75, if that amount is the equivalent of 5 pounds when actually received by the non-resident alien individual.[3]

[2] O. D. 713, Treasury Bulletin 44-20-1278.
[3] O. D. 700, Treasury Bulletin 43-20-1262.

[Page 606.]

Scrip. Scrip issued by a corporation to bondholders in payment of interest upon its bonds is equivalent to cash and is subject to withholding. When a corporation which defaulted in the payment of bond interest is reorganized and the new corporation issues scrip in exchange for the coupons representing the defaulted interest, ownership certificates are required to be filed by the owners covering the face value of the coupons exchanged, the form of certificate depending upon whether or not the bonds are tax-free and whether or not the owner claims exemption from having tax paid at the source. The withholding requirements of the law are not applicable to the interest paid by the terms of the scrip on the defaulted bond interest, unless the scrip is held by non-resi-

dent aliens.[1] Where as a result of the reorganization of a domestic corporation in 1919, bonds and stocks were issued to holders of securities of that corporation, certain of the holders, due to limited participation, receiving scrip certificates, which, when presented with others aggregating a certain amount entitled the holder to a bond of a stated value, together with interest thereon from June, 1919, bonds equal to the aggregate of scrip issued being certified by the trustee under the mortgage and issued to the treasurer of the corporation in trust for the holders of the scrip and the interest coupons of these bonds, which do not contain a tax-free covenant clause, being presented from time to time by the treasurer for payment, accompanied by ownership certificates, Form 1001, revised, he holding the interest so collected in trust to be paid over to the scrip holders; no interest being paid to scrip holders except when in accordance with the above plan they present scrip and receive in exchange a bond together with accrued interest thereon, it has been held that the scrip holders can not be considered owners of the bonds until the bonds are actually delivered in exchange for the scrip. The accrued interest due the scrip holders is, in effect, interest on the scrip and not interest on the bonds; consequently, no ownership certificates are required to be filed by the scrip holders when receiving the accrued interest upon exchanging their scrip for bonds. When bonds are exchanged for scrip held by non-resident alien individuals or non-resident alien corporations, the normal tax of 8% or 10%, respectively, should be withheld from the accrued interest and returned in the manner prescribed by law.[2]

[1] O. D. 279, Treasury Bulletin 20-19-512; O. D. 562, Treasury Bulletin 26-20-1032.

[2] O. D. 680, Treasury Bulletin 41-20-1233.

[Page 606.]

FIDUCIARIES. Bond interest paid to a nonresident alien fiduciary is subject to withholding even though the beneficiaries of the income are citizens or residents of the United States.[1]

[1] O. D. 670, Treasury Bulletin 39-20-1212.

[Page 606.]

Footnote 43.

Add:—O. D. 518, Treasury Bulletin 21-20-956.

[Page 607.]

CORPORATIONS. A bank purchasing abroad coupons of bonds issued by domestic corporations will be held prima facie to be the recipient of income. Ownership certificates should therefore be secured from original owners of bonds in order that the tax may be withheld.[1]

[1] O. D. 220, Treasury Bulletin 11-19-385.

[Page 607.]

AGENTS. The appointment of an agent in this country will exempt a non-resident foreign corporation from the withholding provisions of the statute provided the agent furnishes the person otherwise obliged to withhold with a certificate stating that the foreign corporation has an office or place of business in the United States and that he will make all necessary returns and pay all taxes shown to be due.[1]

[1] O. D. 358, Treasury Bulletin 1-20-661.

[Page 608.]

Footnote 50.

Add. O. D. 561, Treasury Bulletin 26-20-1030.

[Page 609.]

Footnote 53.

Add:—O. D. 50, Treasury Bulletin 1-19-68.

Pending further revision of Form 1078, revised, January, 1920, certificate of alien claiming residence in the United States, the information required by that part of the form reading as follows need not be furnished:

Period employed—From ______________________to________________

Total amount paid_______________________________ $______________

(O. D. 660, Treasury Bulletin 37-20-1194.)

[Page 609.]

Footnote 54.

Add:—O. D. 143, Treasury Bulletin 4-19-224.

[Page 610.]

CHANGE OF STATUS OF EMPLOYEE. As a condition precedent to a refund an employer should require the employee to return the receipts showing the amount of tax previously withheld before making the refund.[1] The fact that an alien has been employed by a resident corporation for at least three months is not *ipso facto* sufficient to permit the employer to refund the amount of any tax withheld.[2] In cases where tax was withheld from wages of employees who refused to sign the old Form 1078, but who have now signed the new Form 1078, the amount of tax should not be refunded by the employer upon execution of the new Form 1078. The amount of tax withheld should be reported on Form 1042, and paid to the collector for the district in which the withholding agent is located, subject to claim for personal exemption. If the personal exemption is not available to the non-resident alien, the amount of tax can be refunded only upon execution of Form 46, accompanied by a complete return of the individual's income from sources within the United States, and evidence establishing the fact that tax has been withheld in excess of the actual liability.[3]

[1] O. D. 302, Treasury Bulletin 24-19-569.

[2] O. D. 254, Treasury Bulletin 15-19-447. Forms 1115 and 1078 should be filed by resident or nonresident aliens in order to secure refund.

[3] O. D. 107, Treasury Bulletin 2-19-158.

[Page 610.]

Footnote 56.
Add:—O. D. 175, Treasury Bulletin 7-19-298.

Footnote 59.
Add:—O. D. 175, Treasury Bulletin 7-19-298.

[Page 611.]

Footnote 60.
Add:—O. D. 128, Treasury Bulletin 3-19-196; O. D. 302, Treasury Bulletin 24-19-569; O. D. 254, Treasury Bulletin 15-19-447.

[Page 612.]

Ownership Certificates. Certain obligations in the use of ownership certificates devolve upon the owners of the bonds,

the collecting agent or bank, and the withholding agent. The certificates supplement the returns of the taxpayer. They show income of the bond owner and are regarded as returns of information in so far as the debtor or paying agent is concerned.[1] It is necessary for the efficient administration of the statute that the post office addresses of debtor corporations be supplied on ownership certificates, but the requirement that the street addresses of the corporations be furnished may be waived.[2] In the case of interest payments on overdue bonds, the interest coupons of which have been exhausted, ownership certificates are required to be filed when collecting the interest in the same manner as if interest coupons were presented for collection.[3]

[1] Bulletin "B", page 21.
[2] O. D. 615, Treasury Bulletin 31-20-1104.
[3] O. D. 392, Treasury Bulletin 5-20-719.

[Page 612.]

Footnote 64.

Bonds of the War Finance Corporation are held not to be Government bonds. (O. D. 284, Treasury Bulletin 21-19-527.)

[Page 613.]

FORMS OF OWNERSHIP CERTIFICATES. Banks or other collecting agents receiving coupons attached to ownership certificates executed on the wrong form, in order to expedite the collection of the interest, are permitted to transfer the necessary information from the erroneous to the proper form, the following notations being stamped in the lower left-hand corner:

"------------------------------------"
(Name and address of bank or collecting agent.)

"By----------------------------------"
(Name of official executing certificate.)

The original certificate should be forwarded with the certificate executed on the proper form by the bank or collecting agent, the original certificate bearing the notation substantially as follows: "Superseded by ownership certificate Form

______," designating the form of certificate executed by the bank or collecting agent.[1]

[1] O. D. 562, Treasury Bulletin 26-20-1031.

[Page 614.]

RULES FOR USE OF FORMS. As a general rule, Form 1000 is used when withholding is required and Form 1001 is used when no withholding is required. Forms 1058 and 1059 are substitute certificates to be used as indicated below in the place of the original ownership certificates which are sent to Washington. Form 1058 is uesd in lieu of original ownership certificate. Form 1001, and Form 1059 is used in lieu of original ownership certificate Form 1000. The use of Form 1087 is indicated in Chapter 5. Form 1001-A is used in connection with foreign items, as defined above. The following is a table indicating the particular form of ownership or substitute certificates to be used in particular cases as stated in the text following the table:

TABLE FOR USE OF OWNERSHIP AND SUBSTITUTE CERTIFICATES.[1]

Classification of Owner	OWNERSHIP CERTIFICATES			SUBSTITUTE CERTIFICATES	
	Bonds of Domestic or Resident Foreign Corporations				
	With Tax-Free Covenant	Without Tax-Free Covenant	Foreign Items[2]	With Tax-Free-Covenant	Without Tax-Free Covenant
Citizen or Resident—					
Individual or fiduciary claiming exemption	1001[6]	1001	1001 A	1058	1058
Individual or fiduciary not claiming exemption	1000		(1000 or) (1001 A[3])	1059	1058
Partnership and Personal Service Corporations[7]	1000	1001	(1000 or) (1001 A[3])	1059	1058
Corporations	1000	1001	1001 A	1058	1058
Non-Resident Alien					
Individual or fiduciary	1000	1000	1001 A	None Permitted	None Permitted
Partnership	1000	1001	1001 A	None Permitted	None Permitted
Corporations[5]	1000[8]	1000	1001 A	None Permitted	None Permitted
Banks receiving coupons not accompanied by Ownership Certificates—Ownership Unknown	1000	1000	(1000 or) (1001 A[4])	....	....
Foreign Governments	1001	1001	(1000 or) (1001 A[9])	....	....
Foreign Charitable or Exempt Corporations	1000	1000	....	....	....

[1] See Reg. 45, Arts. 365-7, 1078; Letter from Treasury Department dated May 20, 1919; I. T. S. 1919, par. 3338; Telegram from Treasury Department dated July 7, 1919; I. T. S. 1919, par. 3474. O. D. 144, Treasury Bulletin 4-19-225; O. D. 520, Treasury Bulletin 21-20-958.

[2] The term "foreign item," as here used, means any dividend upon

the stock of a nonresident foreign corporation or any item of interest upon the bonds of foreign countries or nonresident foreign corporations, whether or not such dividend or interest is paid in the U. S. or by check drawn on a domestic bank. (Reg. 45, Art. 1077.)

[3] 1000 is used in this instance if the foreign country or foreign corporation has a fiscal agent in this country and if the bonds contain a tax-free covenant clause, unless exemption is claimed. (Reg. 45, Art. 1078; Letter from Treasury Department dated May 20, 1919; I. T. S. 1919, par. 3338.)

[4] 1001 A is used in this instance if the owner is known to be a nonresident alien individual, corporation, or partnership, and in the case of bonds not containing a tax-free covenant and stocks of foreign corporations.

[5] A foreign corporation not engaged in trade or business within the U. S., which has a fiscal agent in the U. S., is not a resident corporation. (Letter from Treasury Department dated May 20, 1919; I. T. S. 1919, par. 3338.)

[6] In the case of registered bonds having a tax-free covenant 1000 is used by the withholding agent if the owner files no certificate. That is, if the owner files no certificate the withholding agent must presume that he does not claim exemption from withholding. (Reg. 45, Art. 369.)

[7] Before a corporation can be regarded as a personal service corporation it must have received notice from the Commissioner that its claim to be regarded as a personal service corporation has been approved. (Letter from Treasury Department dated November 20, 1919; I. T. S. 1919, par. 3651.) Personal service corporations are to be treated, so far as practicable, on the same basis as partnerships. Corporations which have received notice that their returns as personal service corporations have been approved may thereafter, and not before, issue Form 1000 in collecting interest from bonds or other obligations of a corporation containing a so-called tax-free covenant clause in the same manner and to the same extent that partnerships are authorized to use that form. The form should bear the stamped or written notation "Approved by the Treasury Department as Personal Service Corporation on (date)." (O. D. 339, Treasury Bulletin 29-19-628.)

[8] A foreign corporation, notwithstanding it claims to be exempt, is required to file Form 1000 (Revised) in collecting interest on bonds issued by domestic or resident corporations, and the debtor corporation, or its withholding agent, is required to pay the tax due. Such foreign corporation, however, has the privilege of establishing its exemption. When a debtor corporation has assumed the payment of the 2% normal tax on the interest derived from its tax-free bonds, owned by an exempt foreign corporation, it may file a claim for refund accompanied by the proof of exemption submitted by the foreign corporation. Otherwise, the foreign corporation should file a claim for refund accompanied by the required proof. (O. D. 616, Treasury Bulletin 31-20-1105.)

[9] Income payable to a foreign government is not subject to tax, but should be reported on line 6 of Form 1001-A, crossing out the word "corporation" and substituting "foreign government". With respect to foreign items presented for collection unaccompanied by an ownership certificate, if the item is a coupon detached from a bond containing a tax-free covenant clause and the debtor organization has a paying agent in the U. S., line 6 of Form 1000 is the proper place for reporting such income. (O. D. 520, Treasury Bulletin 21-20-958.)

[Page 614.]

FORM OF CERTIFICATE WHERE WITHHOLDING REQUIRED. When a debtor corporation fails to withhold the 2% tax where its bonds contain a tax-free clause, and the owner has filed Form 1000, there is no obligation on the bank first receiving the coupons to withhold the tax, as assessment will be made against the debtor or its disbursing agent based on the tax liability as disclosed by Form 1000.[1]

[1] O. D. 56, Treasury Bulletin 1-19-76.

[Page 615.]

FORM OF CERTIFICATE WHERE NO WITHHOLDING REQUIRED. Where a corporation sets aside certain amounts in a sinking fund under the control of a trustee and such fund is invested by the trustee in whole or in part in bonds, the trustee when presenting coupons from the bonds for payment is required to file ownership certificates, Form 1001, revised, whether or not the bonds contain a tax-free covenant clause.[1]

[1] Reg. 45, Art. 541 (a) added by T. D. 3056, Treasury Bulletin 35-20-1173.

[Page 615.]

USE OF SUBSTITUTE CERTIFICATES. The original certificate for which the certificate of the collecting agent is substituted should be indorsed, preferably with a rubber stamp, by the collecting agent as follows:

Owner's certificate No.______________

____

(Name of collecting agent.)

____________________________19____

(Give date of certificate.)

The counterpart of the within certificate bearing like number was attached to the coupons within mentioned for delivery to the debtor or withholding agent, by whom the coupons are payable. In numbering substitute certificates the numeral 1 should be reverted to at the beginning of each calendar year.[1]

Where substitute certificates are used, the name of the bank or collecting agent may be printed or stamped and the facsimile of the signature of the person authorized to sign the substitute certificate for the bank or collecting agent may also be printed or stamped on the certificate. However, in all cases the bank must first file with the Commissioner of Internal Revenue, Sorting Division, a certificate of its authorization in substantially the following form:

(City.) (Date.)

The Commissioner of Internal Revenue, Washington D. C.

The undersigned hereby authorizes the use of the facsimile signature shown below upon all substitute income-tax certificates issued in its name until this authorization is revoked by written notice to you.

(Name of bank or collecting agent.)

By---------------------------------

(Signature of person authorized to sign.)

(Official position.)

(Facsimile signature of person authorized to sign.)

As a convenience to banks and trust companies having a large number of ownership certificates to execute in the collection of interest on bonds, it has been provided that the name of the bank or trust company may be printed or stamped and the facsimile of the signature of the person authorized to

[1] Reg. 45, Art. 367, as amended by T. D. 2967, Treasury Bulletin 6-20-732.

sign for the bank or trust company in executing the said ownership certificates may be printed or stamped on the certificate; provided that in all cases the bank or trust company shall first file with the Commissioner of Internal Revenue, Sorting Division, a certificate of authorization in substantially the following form:[2]

(City.) (Date.)

The Commissioner of Internal Revenue, Washington, D. C.:

The undersigned hereby authorizes the use of the facsimile signature shown below upon all income tax ownership certificates issued in its name until authorization is revoked by written notice to you.

(Name of bank or trust company.)

By------------------------------------
(Sig. of person authorized to sign.)

(Official position.)

(Facsimile signature of person authorized to sign.)

[2] Treasury Department Bulletin "B", page 28.

[Page 616.]

INTEREST COUPONS WITHOUT OWNERSHIP CERTIFICATES. In a case in which a foreign bank placed in the mails to be transmitted to an American firm, a package containing coupons clipped from bonds of a domestic corporation, the ship upon which the package was forwarded was sunk by a submarine and the insurance company which had insured the foreign bank against loss paid to it the face value of such coupons. Subsequently, the insurance company filed an indemnity bond, but settlement of the claim for an amount representing the face value of the coupons was deferred by the

debtor corporation, pending the receipt by it of an ownership certificate from the insurance company, covering the amount of the claim. It was held that the amount representing the face value of the coupons did not constitute income to the insurance company, but was nevertheless income of the bondholders. The insurance company was required to obtain ownership certificates from the owners of the bonds and forward them to the debtor corporation with the claim. If the bondholders were unknown, the insurance company, as payee, was required to furnish a certificate on Form 1000 (Revised).[1] Ownership certificates are required to be filed with respect to interest payments upon first-mortgage participation bonds issued by a trust company and secured by a real estate mortgage deposited with the trustee. In cases where coupons of the bonds are not accompanied by ownership certificates, the first bank is required to furnish a certificate. Where no ownership certificates are filed in connection with interest upon such registered bonds, the withholding agent will be required to prepare certificates.[2]

[1] O. D. 633, Treasury Bulletin 33-20-1136. Since the insurance company paid to the foreign bank the face value of the coupons, without deduction for tax due the United States, the recovery of the excess amount paid was held to be a matter to be adjusted between the insurance company and the bondholders, and between the bondholders and the corporation issuing the bonds.

[2] Treasury Department Bulletin "B", page 31.

[Page 616.]

RETURN OF TAX WITHHELD. If there is not sufficient space on Form 1012, it should be continued on Form 1012-A. Remittances frequently accompany this return. This is improper and should be avoided.[1]

Tax erroneously withheld from the wages of a nonresident alien seaman who can not now be located for the purpose of making refund should be reported on the annual list return, Form 1042, and paid to the Government, and when the seaman is located he should be advised of his right to file claim for refund.[2]

[1] Treasury Department Bulletin "B", page 32.

[2] O. D. 258, Treasury Bulletin 16-19-463.

[Page 616.]

Footnote 77.

Add:—Reg. 45, Art. 368, as amended by T. D. 3018, Treasury Bulletin 22-20-973.

[Page 619.]

Withholding in the Case of Enemies. Payments made after October 6, 1917, to the Alien Property Custodian are in the same category as payments made to or for citizens or residents of the United States. Withholding at the source is accordingly unnecessary except in the case of interest payments on corporate bonds or other obligations containing a tax-free covenant where no exemption is claimed. The Alien Property Custodian should use Form 1000 (Revised) in collecting interest on bonds containing a tax-free covenant and in all other cases should use Form 1001 (Revised), except that in cases in which the Alien Property Custodian shall, under the trading-with-the-enemy act, demand payment to himself of interest accrued upon bonds or other securities not yet reduced to his custody (even though they be registered in the name of an enemy, ally of an enemy, or his agent or trustee), the corporation paying such income to the Alien Property Custodian is authorized to accept from the Alien Property Custodian ownership certificates, Forms 1000 (Revised) and 1001 (Revised), altered by the substitution (in lieu of the certificate required thereon) of a certificate that the Alien Property Custodian is entitled to the interest entered therein with or without deduction of tax, as the case may be. No distinction is to be made between payments directly to the Alien Property Custodian and to his depositaries and between interest on registered bonds and interest on coupon bonds. In the case of enemies or allies of enemies holding a license granted under the provisions of the trading-with-the-enemy act, withholding is required as in the case of any non-resident alien not an enemy or ally of enemy.[1]

Withholding was required in respect of income paid to or

[1] Reg. 45, Art. 375, as amended by T. D. 2969, Treasury Bulletin 7-20-742.

for alien enemies before October 6, 1917.[2] Any tax withheld after that date, which was erroneously withheld, will be deemed to have been erroneously withheld, up to the time of restoration of the property to the original owners by the Alien Property Custodian, but, after the restoration of the property, the tax so withheld if otherwise properly withheld in accordance with the Revenue Act of 1916, as amended, if not in excess of the tax liability of such alien will be deemed to have been properly withheld and, if returned and paid to the Government as income tax, may be taken as a credit against the tax shown to be due by the return required for the respective year to be submitted at or after the restoration of the property by the Alien Property Custodian.[3]

[2] T. D. 2673.

[3] O. D. 657, Treasury Bulletin 36-20-1185.

[Page 619.]

Return of Income From Which Tax Withheld. The amount of normal income tax paid at the source by a debtor corporation in behalf of a bondholder may be credited against the total tax due from the bondholder even though he may be liable to surtax only.[1]

[1] O. D. 423, Treasury Bulletin 13-20-812.

CHAPTER 41.

COVENANTS TO PAY TAXES

[Page 621.]

Footnote 1.

Add.—O. D. 519, Treasury Bulletin 21-20-957.

[Page 622.]

Covenants in Supplementary Instruments. Where neither bonds nor the trust deeds given by the obligor to secure them contain a tax-free covenant, supplemental agreements executed by the obligor corporation and the trustee containing a tax-free covenant and which modify the original trust deeds to that extent are of the same effect from the date of their proper execution as if they had been part of the original deeds of trust, provided proper authority exists for the modification of the trust deeds in this manner. The authority must be contained in the original trust deeds or actually secured from the bondholders.[1]

[1] O. D. 414, Treasury Bulletin 12-20-797.

[Page 623.]

Domestic Corporations Owning No Property and Doing No Business in the United States. A domestic corporation owning no property and doing no business in the United States issuing bonds containing a tax-free covenant, is not absolved from the withholding requirements in the case of bondholders who are citizens or residents of the United States. The situation is not analogous to that of interest from non-resident corporations paid to non-resident alien individuals. Such income is not taxable gross income and need not be reported by the non-resident alien individual. Such interest, however, paid to citizens and residents of the United States is taxable gross income, must be reported by the taxpayer, and a tax upon such income is due the United States. No exception as to

withholding requirements may be made even though the amount of tax withheld and paid to the United States possession or foreign country is claimed by the bondholder as a credit against his income tax liability to the United States Government.[1]

[1] O. D. 455, Treasury Bulletin 15-20-852.

[Page 625.]

Examples of Covenants to Pay Taxes. Where lessees covenant to pay all taxes which during the term of a lease may be lawfully levied, laid or assessed against the rent payable, whether levied or assessed on the same as rental or as income of any person entitled thereto, such lessees are liable to reimburse the lessor not only for the normal Federal income tax, but also for the surtax paid by him on rentals received although such surtax did not come into existence until after the date of the lease, the surtax being a direct tax which may be assessed on rentals when received as income.[1] Under a clause which provided that the lessee should pay "one-third of all taxes or assessments, special or otherwise, and public charges of every kind or nature that shall or may be taxed or assessed against the Des Moines Company or its property during the aforesaid term of years" it has been held that the lessee was under no obligation to pay Federal income tax imposed pursuant to the 1913, 1916 and 1918 Laws upon sums received by the lessor. In making this decision the Court treated the fact that at the time the covenant was made no such taxes were levied, or were apparently to be anticipated, as bearing on the intent of the parties, and held that an intent to include all possible forms of taxation is not conclusively established by the use of sweeping general terms, if by a proper application of the rule of *ejusdem generis*, or other recognized canon, the covenant may be satisfied by a less burdensome construction.[2]

[1] Kimball v. Cotting (Mass.), 125 N. E. 551.

[2] Des Moines Co. v. Chicago Gt. West. Ry. Co., 177 N. W. 90.

[Page 626.]

Footnote 9.

See Codman v. Amer. Piano Co., 229 Mass. 285, 118 N. E. 344. In this case it was held that where a lessee which covenanted to pay all taxes and assessments whatsoever which might be payable "for or in respect of" the leased premises during the term, except assessments for benefits, was not liable to its lessors for the amount of Federal income tax on the amount of rent reserved in the lease, since while the taxes on real estate itself came within the terms of the covenant, taxes on the rentals as income did not. Taxes "for or in respect of" the leased premises were held to mean taxes relating directly to the premises themselves and not to the rent which, when due, was a separate and independent estate.

[Page 628.]

Footnote 13.

Add:——Phila. G. & N. R. Co., v. Phila. R. Ry. Co., 265 Pa. 325, 108 Atl. 528.

CHAPTER 42.

CONSTITUTIONALITY OF THE LAW

[Page 630.]

Construction of Constitutional Provisions. An amendment to a constitution must be construed in connection with the taxing clauses of the original constitution and the effect attributed to them before the amendment was adopted.[1]

[1] Eisner v. Macomber, 252 U. S. 189.

[Page 631.]

Taxing Gains from the Sale of Capital Assets. At the time of going to press it is announced that the Federal District Court in Connecticut has held that gains from the sale of securities by one not a trader therein are not taxable as income.[1]

[1] Brewster v. Walsh, not yet reported.

Footnote 12.

Add:—Eisner v. Macomber, 252 U. S. 189.

[Page 638.]

Want of Due Process of Law. The judicial department cannot prescribe to the legislative department limitations upon the exercise of its acknowledged powers. The power to tax may be exercised oppressively upon persons; but the responsibility of the legislature is not to the courts but to the people by whom its members are elected. A tax will, therefore, not be held void because it is deemed to be too high.[1]

[1] McCray v. U. S., 195 U. S. 27; Spencer v. Merchant, 125 U. S. 345.

[Page 641.]

Footnote 33.

Add:—Brady v. Anderson, 240 Fed. 665, writ of certiorari denied, 244 U. S. 654; T. D. 2494; U. S. v. McHatton, 266 Fed. 602.

CHAPTER 43

WAR-PROFITS AND EXCESS-PROFITS TAX

The Act of March 3, 1917, was the first excess-profits tax law enacted in this country.[1] It was applied only to corporations and partnerships and imposed a tax of 8% on all net income in excess of the sum of $5,000 plus 8% of the actual capital invested.[2] A small amount of tax was collected under this statute for corporations whose fiscal years ended in the succeeding months but any amounts so collected were credited or refunded to the taxpayers. The next law, enacted October 3, 1917, imposed a tax on the net income of individuals, partnerships and corporations, derived from any business or trade. This latter statute (referred to in this Chapter as the 1917 Law) was retroactive to January 1, 1917, and covered the period during which the Act of March 3, 1917, had been in effect. The rates of the 1917 Law as applied to corporations having invested capital were 20% of that part of the net income which exceeded the excess-profits deduction and did not exceed 15% of the invested capital; 25% of that part of the net income which exceeded 15% of the invested capital and did not exceed 20% of the invested capital; 35% of the net income which exceeded 20% of the invested capital and did not exceed 25% of the invested capital; 45% of that part of the net income which exceeded 25% of the invested capital and did not exceed 33% of the invested capital; and 60% of that part of the net income which exceeded 33% of the invested capital.[3] In the case of a trade or business which had no invested capital or not more than a nominal capital, the excess-profits tax was 8% of

[1] 39 Stats. at Large 1000.

[2] The statute defined the term "actual capital invested" to mean (1) actual cash paid in; (2) the actual cash value at the time of payment of assets other than cash paid in, and (3) paid in or earned surplus and undivided profits used or employed in the business; but to exclude money or other property borrowed.

[3] Revenue Act of 1917, § 201.

the entire net income in excess of $3,000 in the case of a domestic corporation, and $6,000 in the case of a domestic partnership, or a citizen or resident of the United States. In the case of a foreign corporation or partnership or a non-resident alien this rate was imposed upon the entire net income without deduction.[4] The Act of February 24, 1919, (referred to in this Chapter as the Revenue Act of 1918, the 1918 Law, or the present law) imposed a tax on income received during the year 1918 in lieu of the tax imposed by the 1917 Law. In view of the increased individual normal and surtax rates upon the income of individuals and partnerships, which in most cases make the income taxes paid by such individuals as high as the income and excess-profits or war-profits taxes paid by corporations engaged in similar business, and in view of the difficulty in administering an excess-profits tax applicable to individuals, it was decided by Congress that the war- and excess-profits taxes should apply to corporations only.[5] It was also recognized that there exists a class of corporations which require very little or no invested capital and whose income is derived mainly from the personal services of the stockholders. Examples of such corporations are corporations composed of engineers or accountants, who might as readily have formed partnerships to carry on their business. Such corporations are called "personal service corporations" and are treated as though they were partnerships. No excess-profits tax is imposed upon their net income but the stockholders of the personal service corporation are taxable upon the entire net income of the year, whether or not such income is distributed in the form of dividends. The tax imposed by the present law combines two general principles of taxation: (a) that of a war-profits tax, which is usually considered to be a tax on the excess of profits made during the years of the war period over the normal profits of the years prior to the war and (b) an excess-profits tax, which is considered as a tax upon the profits in excess of a specified percentage representing an approximate

[4] Revenue Act of 1917, § 209.

[5] Report of the Committee on Ways and Means on the Revenue Bill of 1918, September 3, 1918.

normal return on the invested capital. The law, however, does not adhere to a clear distinction between war-profits and excess-profits since the war-profits tax combines a feature of the excess profits tax in that a minimum deduction of 10% of the invested capital is allowed regardless of the earnings of the corporation during the prewar period. Under the excess-profits method of computing the tax the rate of 1918 was 30% of that part of the net income which exceeded the excess-profits deduction and did not exceed 20% of the invested capital and 65% of that part of the income which exceeded 20% of the invested capital. The war-profits tax rate is a single rate of 80% in excess of the war-profits credit.[6] This combination of principles applied generally, however, only to income of the year 1918. For subsequent years the war-profits tax is discarded and the excess-profits tax alone imposed, except as to income received from government contracts, as more fully stated in a following paragraph. The rate of the excess-profits tax for the taxable year 1919 (and subsequent years until the law is changed) is 20% on that part of the net income which exceeds the excess-profits credit and does not exceed 20% of the invested capital, and 40% on the remaining net income.[7]

[6] Revenue Act of 1918, § 301 (a). It has been estimated that under the 1917 Law, the average amount of excess-profits tax was about 30% of the net income of taxable corporations for the year 1917. It has been conjectured that the war-profits and excess-profits taxes absorbed on an average about 45% of the 1918 income. In addition the income tax absorbed 12% of the remainder so that probably about one-half of the net income of corporations for the year 1918 was paid to the Federal Government by way of war-profits, excess-profits and income taxes.

[7] Revenue Act of 1918, § 301 (b).

Individuals. Individuals are not subject to the excess-profits tax.[1] Since individuals were not allowed to file returns on the

[1] Under the Revenue Act of 1917, individuals were subject to the excess-profits tax if they had an aggregate net income in excess of $6,000 from trades, businesses, occupations or professions (with certain exceptions). Reg. 41, Art. 12 and 13. The terms "trade" and "business" include professions and occupations. For a definition of the term "business" see page 372 of the 1920 edition. Several cases arose under the Revenue Act of 1917 in definition of the terms "trade" and

"business" a few of which are given below. An expert oil man who devoted his time and money to the purchase and sale of oil and gas leases and to the promotion of corporations developing such leases, and who in 1917 disposed of his entire holdings of the capital stock of certain corporations in which he owned all but the qualifying shares and of which he was an active officer, was held subject to the 1917 excess-profits tax on the profits realized in 1917 from the sale of his interests in such companies. (A. R. M. 41, Treasury Bulletin 16-20-871.) The decisive point in the above decision seems to have been the fact that the taxpayer was the managing officer of the corporations. The sale of rights acquired through the ownership of stock in any corporation in which an individual was not a managing officer or agent was considered an isolated transaction and any profit derived therefrom was not subject to the 1917 excess-profits tax (A. R. M. 41, Treasury Bulletin 16-20-871). Likewise profits realized from the sale of fractional interests in various vessels by an individual having no control of the management of such vessels were not subject to the 1917 excess-profits tax unless such individual gave enough time and attention to the buying and selling thereof as to constitute a trade or business. (A. R. R. 65, Treasury Bulletin 16-20-870.) A physician who owned a farm and a part interest in certain oil interests, but who spent practically his entire time in 1917 in the practice of his profession, the farm being rented out on a cash rental basis and the management of the interest in the oil leases being in the hands of another individual was held not engaged in the business of farming or the purchase, promotion or sale of oil properties in 1917, and consequently not subject to the 1917 excess-profits tax with respect to a profit derived from the sale of the farm and the interest in the oil leases. (A. R. M. 40, Treasury Bulletin 17-20-879.) Amounts received for professional and literary work have been held to be income arising from a vocation. (A. R. R. 247, Treasury Bulletin 34-20-1155.)

basis of their fiscal years under the 1917 Law,[2] no individual has paid a tax on 1918 income under the 1917 Law, and, therefore, the 1918 Law contains no provision with respect to individuals such as the provision[3] with respect to partnerships for redetermining the tax due on 1917 income.

[2] See p. 156 of the 1920 edition.
[3] Revenue Act of 1918, § 335 (c).

Partnerships. Partnerships are not subject to the excess-profits tax under the present law.[1]

[1] Partnerships were subject to the 1917 excess-profits tax (Reg. 41, Art. 11). A partnership which was dissolved in July, 1917, was held not to be relieved from such tax on the ground that its dissolution

antedated the passage of the Act. The Act was passed on October 3, 1917, and made retroactive as of January 1, 1917. (A. R. R. 43, Treasury Bulletin 12-20-794; Reg. 41, Art. 5.) A partnership which dissolved about 1902 and whose quick assets, goodwill and firm title were sold to an individual who carried on business thereafter for its individual account under the old firm name, was held subject to the 1917 excess-profits tax with respect to the profits derived from certain transactions in 1917 involving the purchase and sale of sugar. (A. R. R. 211, Treasury Bulletin 31-20-1108.) It has been held under the Revenue Act of 1917 that stocks owned by individual partners could not be recognized as invested capital of the partnership even though purchased from profits distributed by the partnership and purchased for the purpose of advancing the interests of the partnership. (A. R. R. 17, Treasury Bulletin 3-20-696.)

PARTNERSHIPS WHICH PAID A TAX ON 1918 INCOME. If a partnership made a return under the 1917 Law for a fiscal year beginning in 1917 and ending in 1918, and paid the tax, a certain proportion thereof will be refunded. This amount is to be determined by taking the same proportion of the tax so paid which the proportion of the fiscal year falling in 1917 was to the entire fiscal year. Thus, if one-fourth of the fiscal year fell in 1917 and three-fourths in 1918, three-fourths of the tax which has been paid will be refunded immediately as a tax erroneously or illegally collected.[1]

[1] Revenue Act of 1918, § 335 (c). See Chapter 37 for procedure in claiming refund or abatement. Excess profits tax paid by partnership with respect to income received during 1918 can not be applied as credit to tax due from individual members for taxable year 1918. In such cases claim for refund on Form 46 should be filed by the partnership. (O. D. 180, Treasury Bulletin 7-19-310.)

Personal Service Corporations. Personal service corporations are not subject to the excess-profits tax, but are taxed as partnerships.[1] Such corporations are described in a preceding chapter.[2]

[1] Revenue Act of 1918, §§ 300 and 200.

[2] Chapter 11. The 1917 Law imposed a tax of 8% upon a trade or business having no invested capital or not more than a nominal capital. (Revenue Act of 1917, § 209.) This provision is omitted from the present law but in its place are the provisions respecting personal service corporations. Under the 1917 Law it was held that business

concerns which rendered professional or personal services would not be taxed on the basis of invested capital merely because of the capital if the employment of such capital was necessitated by delay and irregularity in the receipt of fees, etc., or if such capital was wholly or mainly used as a fund from which to advance salaries, wages, etc., or provide office furniture, accommodations and equipment. Agents and brokers were held to be taxable at the graduated rates with reference to invested capital if they employed a substantial amount of capital whether to lend to principals or to carry goods on their own account but otherwise were taxable only at the flat rate of 8%. (Reg. 41, Arts. 72 and 73.) It has been held under the 1917 Law that a retailing corporation, the stock of which was owned by two stockholders who were actively engaged in the business and were the principal salesmen, and which employed no capital except in paying for merchandise consigned to it by the factory and for the payment of the freight charges thereon, is purely a commercial enterprise and is not entitled to assessment under Section 209 of the Revenue Act of 1917, even though the capital used was small in amount and even though the direct use of capital by the corporation could have been avoided by having the purchasers make the customary deposits when placing their orders, no stock being carried by the corporation other than that passing through the shop for test before delivery. (T. B. R. 58, Treasury Bulletin 19-19-492.) A corporation engaged in the business of negotiating sales of real estate for clients and the collection of rents of properties listed with it for renting, its total income being derived from commissions on such business. the corporation not owning any real estate and all its stockholders devoting their entire time and attention to the business with the exception of one stockholder owning 10 shares out of 500 (who devoted part of his time in the business), has been held entitled to assessment under the provisions of Section 209 of the Revenue Act of 1917. The company involved employed two salesmen on the basis of commissions on the sales made by them, but only a small proportion of the net income was due to the activities of these salesmen. The company did not own, nor use capital in its business. (A. R. R. 210, Treasury Bulletin 31-20-1097.) A company which had never owned any lands, timber, plant, mill or yard, and which had never done any manufacturing or carried any stock of manufactured lumber, but whose principal business consisted of buying lumber from manufacturers and reselling the same to its own customers, such business being conducted by the partners personally with the assistance of a small clerical office force of one bookkeeper and two stenographers, has been held not to be a broker within the accepted definition of that term. In making this decision, the Court said: "They buy and sell lumber and undertake and assume all the risks and enjoy all the benefits of a merchandising business. They employ a large amount of capital; their income is dependent upon their personal services and efforts

only in the same way that the farmer, who works his own farm, or the merchant who conducts his own store derives his income from his individual endeavors." (Cartier-Holland Lumber Co. v. Doyle, U. S. Dist. Ct., West. Dist. of Mich., So. Div., T. D. 3080.) The business of stevedoring has been held to be primarily trafficking in the labor of others and a stevedoring company has therefore been denied assessment under the provisions of Section 209. (A. R. R. 213, Treasury Bulletin 32-20-1113.) The income of a company organized with a small amount of capital stock, none of which was paid up, and which later secured a lease to wharf property, no bonus being paid for the lease, the business of the company being subletting of this leased property, is derived chiefly from the possession of a capital asset which is not capital in name only, but a real tangible asset. (A. R. R. 315, Treasury Bulletin 46-20-1307.)

PERSONAL SERVICE CORPORATIONS WHICH PAID A TAX ON 1918 INCOME. If any corporation which under the present law is held to be a personal service corporation has filed a return and paid a tax under the 1917 Law for a fiscal year beginning in 1917 and ending in 1918, a portion of the tax so paid will be refunded. The amount to be refunded is determined by the proportion of the fiscal year falling in 1918 to the entire fiscal year. Thus, if five months of the fiscal year fell in the calendar year 1918, five-twelfths of the tax paid on the income of the full fiscal year will be refunded.[1] If the tax has been paid claim for refund should be filed.[2]

[1] Revenue Act of 1918, § 335 (c).

[2] See Chapter 37 of the 1920 edition for procedure as to refund.

Corporations Engaged Partly in Personal Service Business. Where a part of the net income of a corporation is derived (1) from a trade or business (or a branch thereof) in which the employment of capital is necessary and (2) a part (constituting not less than 30% of its total net income) is derived from a separate trade or business which, if it constituted the sole trade or business, would bring the corporation within the class of personal service corporations, the tax upon that part of the net income which is derived from the use of capital is separately computed (allowing in such computation only the same proportionate part of the war-profits and excess-profits credits) and the tax upon the second part of the net income

is the same percentage thereof as the tax computed upon the first part of the net income is of such first part.[1] This provision will apply in the case of partial personal-service corporations until the point is reached where the non-personal-service element becomes negligible, under which conditions such corporations would make returns as personal-service corporations.[2] Where a corporation doing a commission and brokerage business satisfies the requirements of a personal-service corporation, except that it in part employs capital, surplus, and borrowed funds to make large advances to customers and receives more interest than it pays as a result of such transactions, it should be assessed under this provision. The income from commissions and brokerage should be considered as arising from personal service, and the remainder of the income as derived from the use of capital.[3]

[1] Revenue Act of 1918, § 303.

[2] O. D. 79, Treasury Bulletin 1-19-114.

[3] T. B. M. 50, Treasury Bulletin 12-19-410.

APPORTIONMENT OF INVESTED CAPITAL AND NET INCOME. For the purpose of determining whether or not a corporation partly partaking of the nature of a personal service corporation is within the scope of the statute and also for the purpose of establishing the basis for the computation of the tax, the corporation is required to apportion or allocate its invested capital between each trade or business or branch thereof as nearly as may be in accordance with the actual facts, and to submit with its return an explanatory statement setting forth the manner in which the apportionment of the invested capital employed in the production of each part of its net income has been determined. There must be assigned to any personal service trade or business or branch thereof an amount of invested capital at least as great as that which would ordinarily be employed by a personal service corporation of similar size and standing for the payment of salaries and office expenses, maintenance of library and equipment, credit advances to clients, etc.[1]

[1] Reg. 45, Art. 741. For the method of determining the portion

of the net income from each trade or business or branch thereof see p. 650 of the 1920 edition.

COMPUTATION OF TAX UPON NET INCOME. (1) The tax upon the nonpersonal service part of the net income is computed upon the basis of (a) such part of the entire average net income for the prewar period as was derived from the same trade or business or branch thereof; (b) such part of the entire average invested capital for the prewar period as was employed in the production of the part of the net income for that period determined under (a); (c) such part of the entire invested capital for the taxable year as has been employed in the production of the net income upon which the tax is being computed; and (d) the same proportion of the specific exemption and credits as the proportion which the part of the net income upon which the tax is being computed is of the entire net income. If the corporation was in existence during the prewar period, but did not conduct this trade or business or branch thereof during that period, the war-profits credit is 10% of the invested capital for the taxable year. (2) The tax upon the personal service part of the net income is the same percentage thereof as the tax computed under (1) is of the non-personal service part of the net income. The tax under this paragraph may in no case be less than 20 per cent. of the personal service part of the entire net income, unless the tax upon the entire net income if computed in the ordinary way would be less than 20 per cent. of such entire net income. In that event, and in any case in which the amount of the total tax as computed above is the same as or greater than the tax as computed in the ordinary way, the tax must be computed as if all the income was derived from the use of capital.[1]

[1] Reg. 45, Art. 742. See illustration No. 5, Appendix to the 1920 edition.

Corporations. All corporations except those expressly exempt by the statute are subject to the excess-profits tax. The term "corporations" includes associations, joint-stock companies and insurance companies.[1] A corporation dissolved

[1] See Chapter 10 of the 1920 edition for discussion of the definition of the term "corporations."

prior to February 25, 1919, when the present law went into effect, but which was in receipt of income after January 1, 1918, will be held subject to the tax imposed by the present law for the reason that the law is retroactive to the first day of January, 1918.[2]

[2] See letter from Treasury Department dated November 17, 1917; W. T. S. 1919, ¶ 757.

EXEMPT CORPORATIONS. Corporations exempt from the income tax are also exempt for the purpose of excess-profits tax.[1] In addition, any corporation whose net income for the full taxable year of twelve months is less than $3,000 is exempt from this tax. If the taxable period is less than twelve months the corporation is exempt from the tax if its net income for the period is less than the same proportion of $3,000 as the number of months in the period is of twelve months, any fractional part of a month being counted as the number of days in such part of a month divided by 30.[2]

[1] Revenue Act of 1918, § 304 (a). See Chapter 13 of the 1920 edition for list of exempt corporations under the income tax law.
[2] Revenue Act of 1918, § 304 (b); Reg. 45, Art. 751.

CORPORATIONS DERIVING INCOME FROM GOVERNMENT CONTRACTS. Special provisions apply to corporations deriving income from government contracts as defined in the following paragraph. For the taxable year 1919 and thereafter every corporation which derives in such year a net income of more than $10,000 from any government contract or contracts made between April 6, 1917, and November 11, 1918, both dates inclusive, will be required to pay the tax at the 1918 rates on the net income attributable to such government contracts, such tax to be computed according to the rule stated in a subsequent paragraph.[1] Corporations which have no prewar period and which were in receipt of 50% or more of gross income during the taxable year from gains, profits, commissions or other income derived from a government contract or contracts made between April 6, 1917, and November 11,

[1] Revenue Act of 1918, § 301 (c). See p. 650 and illustration No. 4, Appendix of 1920 edition.

1918, both dates inclusive, will be limited to a war-profits credit of 10% of the invested capital of the taxable year,[2] although other corporations (other than corporations a majority of whose stock at any time during the taxable year is owned or controlled, directly or indirectly, by a corporation which was in existence during the whole of at least one calendar year during the prewar period) which had no prewar period may claim a higher deduction if the earnings of similar corporations during the prewar period were more than 10%. Corporations 50% or more of whose gross income for the taxable year consists of gains, profits, commissions or other income derived on a cost-plus basis from a government contract or contracts made between April 6, 1917, and November 11, 1918, both dates inclusive, will not be allowed to avail themselves of the remedial provision which will permit other corporations to be assessed on the basis of the tax paid by representative corporations.[3] It is to be noted that the first two provisions refer to government contracts generally while the third provision is limited to cost-plus contracts. A corporation organized after August 1, 1914, and not a successor to a then existing business, 50% or more of whose gross income consists of gains, profits, commissions or other income derived from government contracts made between April 6, 1917, and November 11, 1918, both dates inclusive, cannot be considered as affiliated with any other corporation for the purpose of making consolidated returns.[4]

If in 1919 a corporation derives a profit in excess of $10,000 from government contracts, but sustains a net loss on other operations, it may deduct the amount of such loss in ascertaining its net income subject to tax. If the amount of the excess-profits credits exceeds the company's total net income from all sources for 1919 no tax will be imposed upon the portion of its net income for that year which was derived from government contracts.[5]

[2] Revenue Act of 1918, § 311 (d).

[3] Revenue Act of 1918, § 327 (d). See p. 699 of the 1920 edition.

[4] Revenue Act of 1918, § 240 (a). See p. 708 of the 1920 edition.

[5] O. D. 532, Treasury Bulletin 22-20-979. Since the company's net income included an item of net profit from Government contracts in

excess of $10,000, it will be required to supply fully all of the data called for by the supporting schedules of Form 1120-S.

GOVERNMENT CONTRACTS. A government contract is defined in the law to be (a) a contract made with the United States, or with any department, bureau, officer, commission, board, or agency, under the United States and acting in its behalf, or with any agency controlled by any of the above if the contract is for the benefit of the United States, or (b) a sub-contract made with a contractor performing such a contract if the products or services to be furnished under the sub-contract are for the benefit of the United States. The term "Government contract or contracts made between April 6, 1917, and November 11, 1918, both dates inclusive," when applied to a contract of the kind referred to in clause (a) of this paragraph, includes all such contracts which, although entered into during such period, were originally not enforceable, but which have been or may become enforceable by reason of subsequent validation in pursuance of law.[1] The same applies to procurement orders issued after November 11, 1918, in confirmation of informal orders entered into prior to November 12, 1918.[2] The term "contract" has a definite commercial meaning and is broad enough to include any reciprocal promise or engagement whether or not evidenced by a formally executed document. It may be either oral or written, and a contract entered into with an agent is binding upon the principal. The fact that a formal contract was executed after November 11, 1918, would not affect the status of the original contract unless such contract was thereby revoked or supplanted, but would be further evidence of the contract and in confirmation of it. The fact that a formally executed contract bears a date subsequent to the date of offer and acceptance, if that be the case, will not change this conclusion. It is held, therefore, that the acceptance of an award by an agent for a principal constitutes a Government contract even though the formal contract bears a date subsequent to November 11,

[1] Revenue Act of 1918, Section 1.
[2] O. D. 394, Treasury Bulletin 5-20-721.

1918.[3] Contracts with the American Red Cross are considered Government contracts.[4] The term "Government contract" includes contracts relating to sales of standard goods and services at open market prices as well as those of a special nature,[5] and includes contracts made with the United States, even though not connected with the prosecution of the war.[6]

[3] O. D. 540, Treasury Bulletin 24-20-993.
[4] O. D. 261, Treasury Bulletin 17-19-468.
[5] O. 916, Treasury Bulletin 21-19-519.
[6] O. D. 677, Treasury Bulletin 41-20-1228.

AMENDED GOVERNMENT CONTRACTS. A government contract entered into in 1917, amended as to some of its provisions in 1918, and further modified in 1919, is in effect the same contract as entered into in 1917 if the original contract has not been revoked or supplanted by a new contract.[1]

[1] O. D. 295, Treasury Bulletin 24-19-557.

CONTRACTS UNDER THE NAVAL APPROPRIATION ACTS. Contracts entered into pursuant to the Naval Appropriation Acts of March 4, 1917, and July 1, 1918, if entered into between April 6, 1917, and November 11, 1918, are "government contracts," even though these acts by their terms made obligatory compliance with all orders placed by the President, and authorized the President to take immediate possession of a factory upon failure to comply allowing such reasonable compensation as he should determine. Such contracts are not to be placed in a category different from other contracts merely because they were given under the authority of a statute providing a penalty for failure to comply therewith.[1]

[1] O. D. 477, Treasury Bulletin 17-20-889.

WHAT ARE NOT GOVERNMENT CONTRACTS. Contracts entered into between a taxpayer and the Knights of Columbus or the Young Men's Christian Association are not considered government contracts.[1] A contract entered into on May 1, 1918, with the Director General of Railroads for certain cars

[1] O. D. 261, Treasury Bulletin 17-19-468.

for the account, use and benefit of various railroads under Federal control is not "a government contract" for the reason that the cars are not for the use of or for the account of the United States.[2] Sales of goods from existing stocks where delivery is immediate are not government contracts.[3]

[2] O. D. 224, Treasury Bulletin 12-19-394.
[3] O. 916, Treasury Bulletin 21-19-519.

SUBCONTRACTORS. A corporation which contracted with another corporation to manufacture and deliver machinery to be used in manufacturing ammunition, but did not produce or furnish ammunition or any component part thereof, nor perform any direct service in connection with the production of ammunition manufactured by another corporation under contract for the United States Government, is not a subcontractor.[1] A subcontract entered into subsequent to November 11, 1918, based on a principal contract to furnish a product for the benefit of the United States entered into between April 6, 1917, and November 11, 1918, is held to constitute a Government contract.[2]

[1] O. D. 359, Treasury Bulletin 2-20-666.
[2] O. D. 662, Treasury Bulletin 38-20-1200.

GOLD-MINING CORPORATIONS. In the case of a corporation engaged in the mining of gold, that portion of its net income derived from the mining of gold is exempt from excess-profits tax. The tax on the remaining portion of its net income is computed in the following manner: The tax is first computed on the entire net income but only such proportion thereof as the proportion of net income derived from sources other than gold mining bears to the entire net income, is taken to be the amount due.[1]

[1] Revenue Act of 1918, § 304. See illustration No. 6, Appendix to 1920 edition.

Allocation of Net Income to Particular Source. In the case of corporations deriving income from government contracts, or from mining or from personal service trade or business, and in any other cases where it is necessary to determine the por-

tion of the net income derived from or attributable to a particular source, the corporation is required to allocate to the gross income derived from such source, and to the gross income derived from each other source, the expenses, losses and other deductions properly appertaining thereto, and to apply any general expenses, losses and deductions (which can not properly be otherwise apportioned) ratably to the gross income from all sources. The gross income derived from a particular source, less the deductions properly appertaining thereto and less its proportion of any general deductions, is the net income derived from such source.[1] If exact determination of income arising from Government contracts distinctively from other income is impossible, an approximation based on the proportion which sales to the Government bears to other sales should be used only in case approximations based on the respective cost and selling price are inapplicable. The approximation should be based upon the allocation of costs and allocation of selling price, in the most accurate manner possible from available records.

Amortization is not to be charged exclusively against income from Government contracts, and selling and administrative expenses not applicable to the Government contracts should not be so charged.[2] The corporation must submit with its return a statement fully explaining the manner in which such expenses, losses and deductions were allocated or distributed.

[1] Reg. 45, Art. 715.

[2] A. R. M. 1, Treasury Bulletin 26-19-597. See paragraph below on "Advertising Expenses."

ADVERTISING EXPENSES. Advertising and sales promotion are not a part of the necessary expenses of Government contracts, except as relating to such contracts, and are not proper deductions from the gross income derived from Government sales. Such expenditures, if entered into on a large scale at a time when the Government was doing practically no commercial business, may be treated either as an expense of the year in which incurred and deducted from the commercial income only, or they may be treated as deferred items in the balance sheet and set up as good will thereon, being in the nature of

expenditures for the building up of future business and not for the business secured during the taxable year in which such expenditures were incurred.[1]

[1] O. D. 394, Treasury Bulletin 5-20-721.

INVENTORIES OF GOVERNMENT CONTRACT MATERIAL. In so far as stock purchased for Government contracts is used or useful for commercial purposes no separate inventory thereof need be made for Government contract accounting, such inventories being treated as commercial inventories in the ordinary course at the close of the taxable year 1919. If, however, a portion of such goods purchased is useful only for Government contracts and is still on hand at the close of the taxable year 1919, such goods should be inventoried at the then value if lower than cost and assigned to the Government contract section of the income statement for that year.[1]

[1] O. D. 394, Treasury Bulletin 5-20-721.

Taxable Year. The term "taxable year" means the calendar year or the fiscal year ending during such calendar year, upon the basis of which net income is computed for the purpose of the income tax. The first taxable year under the Revenue Act of 1918 is the calendar year 1918 or any fiscal year ending during the calendar year 1918.[1]

[1] Revenue Act of 1918, §§ 300 and 200.

Fiscal Year. The term "fiscal year" means an accounting period of twelve months ending on the last day of any month other than December.[1] If a corporation keeps its accounts on the basis of a fiscal year, the law requires that it report its income on that basis, and not at its option either on that basis or on the basis of the calendar year as was the rule formerly.[2]

[1] Revenue Act of 1918, § 300 and § 200.
[2] Revenue Act of 1918, § 232, § 212 (b) and § 200.

Prewar Period. The term "prewar period" means the calendar years 1911, 1912 and 1913, or, if a corporation was not in existence during the whole of such period, then as many of

such years during the whole of which the corporation was in existence. Thus, if a corporation was in existence during the entire year 1913, that year becomes its prewar period, but if in existence only a part of the year 1913, it is deemed to have no prewar period and becomes taxable under the provisions applying to corporations formed after the prewar period.[1]

[1] Revenue Act of 1918, § 310. Under the 1917 Law the earnings of the pre-war period determined the amount of the excess-profits deduction, between the limits of 7% and 9% of the invested capital. Under the present law no reference is made to the pre-war period in ascertaining the excess-profits credit, since that credit is 8% of the invested capital regardless of the prewar earnings. But the prewar earnings and prewar invested capital are used in computing the war-profits credit under the Revenue Act of 1918.

Statement of the Tax. The tax imposed by Title III of the Revenue Act of 1918, is in lieu of the tax imposed by Title II of the Revenue Act of 1917, but in addition to the other taxes imposed by the Revenue Act of 1918. The tax is imposed upon the net income of every corporation,[1] whether or not derived from a business or trade or from investment or otherwise.[2] Briefly stated, the excess-profits tax is computed on the entire net income of the taxable year after deducting the excess-profits credit, at the rates specified in the statute. For the taxable year 1918 the war-profits tax was computed on the entire net income in excess of the war-profits credit at the rate specified in the Act, and whichever of the two taxes (the excess-profits or war-profits) was the greater was assessed. The rates of tax, net income, invested capital, excess-profits credit and war-profits credit are more fully discussed in the following paragraphs.

[1] Revenue Act of 1918, § 301.
[2] See Revenue Act of 1918, §§ 213 (a), 233 (a).

Rates of Tax for 1918. The rates of tax are stated in the form of three brackets as follows:[1] First bracket, 30% of the amount of net income in excess of the excess-profits credit and not in excess of 20% of the invested capital. If the excess-profits credit equalled or exceeded 20% of the invested capital,

[1] Revenue Act of 1918, § 301 (a).

no tax was imposed under this bracket. The second bracket provided a rate of 65% of the amount of net income in excess of 20% of the invested capital. If, however, the excess profits credit exceeded 20% of the invested capital, this rate was applied only to the amount of net income in excess of such excess-profits credit.[2] The third bracket provided that there should be added to the tax computed under the first and second brackets the sum, if any, by which 80% of the amount of net income in excess of the *war-profits credit* exceeded the amount of tax computed under the first and second brackets. As a practical matter, if 80% of the amount of net income in excess of the war-profits credit was greater than the tax computed under the first and second brackets, the 80% tax became the tax due from the corporation and the computation under the first and second brackets might be disregarded.[3]

[2] Revenue Act of 1918, § 301 (d). See illustration No. 2, Appendix to 1920 edition.

[3] This device of adding the excess amount of the war-profits tax over the excess-profits tax to such excess-profits tax was invented by the Senate to overcome the objection to the provision in the bill as originally drafted, which expressly provided for an alternative excess-profits or war-profits tax, the larger of the two being the amount asesssed. The change made by the Senate did not in substance change the tax and it was still a tax computed by two alternative methods, the one productive of the greater amount of revenue being applied to the taxpayer.

Rates of Tax for 1919 and Subsequent Years. In the case of all corporations other than those referred to in the following paragraphs, the rates for 1919 and subsequent years computed under the first bracket as above indicated are 20% instead of 30% and under the second bracket are 40% instead of 65%. No tax is imposed under the third bracket.[1]

[1] Revenue Act of 1918, § 301 (b). See illustration No. 1, Appendix to 1920 edition.

FISCAL YEAR ENDING IN 1919. If a corporation makes a return for a fiscal year beginning in 1918 and ending in 1919 the tax for such fiscal year is determined as follows: The amount of tax for the entire fiscal year computed at the 1918 rates is first determined and such proportion thereof as the

part of the fiscal year falling in 1918 bears to the entire fiscal year is assessed as a portion of the tax. Similarly the 1919 rates are applied to the entire net income for the fiscal year and such portion assessed as the proportion of the fiscal year in 1919 bears to the full fiscal year.[1] The sum of the two portions thus ascertained is the tax for the fiscal year.

[1] Revenue Act of 1918, § 335 (b); illustration No. 8, Appendix to 1920 edition. The same principles governed the computation of the tax for a corporation with a fiscal year beginning in 1917 and ending in 1918. (Revenue Act of 1918, § 335.) Any amount heretofore or hereafter paid on account of the tax imposed for such fiscal year by the Revenue Act of 1917, is to be credited toward the payment of the tax so computed, and if the amount so paid exceeds the amount of tax so computed the excess is to be credited or refunded to the corporation. Corporations whose fiscal years ended in 1918, may have filed a return and paid the tax for the full fiscal year under the provisions of the Revenue Act of 1917. In such case the tax is to be recomputed in the manner indicated and from the amount so found to be due should be deducted the amount of excess-profits tax heretofore paid on the basis of the full fiscal year. It follows that the income tax for the same period must also be computed according to the rule in § 205 (a) of the 1918 Law after having deducted the excess-profits taxes as recomputed.

CORPORATIONS DERIVING INCOME FROM GOVERNMENT CONTRACTS. For the taxable year 1919, and each taxable year thereafter, the rates to be applied to corporations which derive in such year a net income of more than $10,000 from any Government contract or contracts made between April 6, 1917, and November 11, 1918, both dates inclusive, are determined as follows: (1) the tax will be computed at the 1918 rates on the entire net income of the corporation, in the computation of which the excess-profits credit and war-profits credit applicable to the taxable year[1] will be used, and (2) the tax will also be computed on the entire net income of the taxable year at the 1919 rates. The sum of (a) such portion of the tax computed under (1) as the net income attributable to such Government contract or contracts bears to the entire net income and (b) such portion of the tax computed under (2) as the part of net income not attributable to such Government contract or contracts bears to the entire income will be the amount to be

[1] O. D. 378, Treasury Bulletin 3-20-695.

paid by the corporation.[2] The method of computing the tax is illustrated below.[3] In the case of a fiscal year corporation this computation should be based on the entire net income for the fiscal year even though no part of the income from Government contracts was derived after January 1, 1919. It is a fundamental principle that no adjustment will be made even though it can be definitely shown what proportion of the income was derived during each portion of the fiscal year.[4] If a corporation has a net income from a Government contract and sustains a net loss from other operations, in the submission of a fiscal year return for a period ending in 1919 the loss may be deducted from the income from the Government contract.[5]

[2] Revenue Act of 1918, § 301 (c). See p. 650 of 1920 edition for rule as to allocation of income.

[3] See illustration No. 4, Appendix to 1920 edition.

[4] T. B. M. 4, Treasury Bulletin 1-19-113.

[5] A. R. M. 5, Treasury Bulletin 26-19-620.

Maximum Limit of Tax. The Revenue Act of 1918 for the first time fixes a maximum limit of tax. In no case will the tax imposed on the net income for the taxable year 1919 or subsequent years, be more than 20% of the amount of net income in excess of $3,000 and not in excess of $20,000, plus 40% of the amount of net income in excess of $20,000. On income of the year 1918 the maximum was 30% of the amount of net income in excess of $3,000 and not in excess of $20,000, plus 80% of the amount of net income in excess of $20,000. In the case of corporations deriving more than $10,000 of net income from Government contracts in 1919 or subsequent years, these limits will apply to the respective amounts of tax computed under the 1918 and 1919 rates, by reason of the provision taxing 1919 income from Government contracts at 1918 rates. Thus, on that part of the net income derived from Government contracts the maximum limit of 30% and 80% will apply while to that not derived from Government contracts the maximum limit of 20% and 40% will apply. This limit is not intended to increase the tax but to reduce it in cases where the tax calculated in the ordinary manner is greater than the maxi-

mum computed according to the rule stated in this paragraph.[1] The limitation will generally operate only in the case of corporations with very small invested capital.[2] It is applied to the consolidated net income of affiliated corporations and may not be construed to apply separately to the net income of each unit included in the return.[3]

[1] Revenue Act of 1918, § 302. See illustration No. 10, Appendix to 1920 edition. In calculating this maximum limit it is to be noted that foreign corporations receive the benefit of a specific exemption of $3,000, even though they are not accorded such exemption ordinarily (Revenue Act of 1918, Sec. 312; O. D. 402, Treasury Bulletin 6-20-735). This conclusion is rendered inescapable by the use of the words "in no case" in Section 302.

[2] An invested capital of less than $71,428.58.

[3] O. D. 80, Treasury Bulletin 1-19-115.

SALE OF MINES, OIL OR GAS WELLS. In the case of a *bona fide* sale of mines, oil or gas wells, or any interest therein, where the principal value of the property has been demonstrated by prospecting or exploration and discovery work done by the taxpayer, the portion of the war-profits and excess-profits tax attributable to such sale cannot exceed 20% of the selling price of such property or interest.[1] To apply this provision to a particular case the corporation should compute the war-profits and excess-profits taxes in the ordinary way upon its net income, including its net income from any such sale. The proportion of the total tax indicated by the ratio which the taxpayer's net income from the sale of the property, allocated to such source by the proper method,[2] bears to its total net income is the portion of the tax attributable to such sale, and if it exceeds 20% of the selling price of the property, such portion of the tax will be reduced to 20% of such selling price.[3]

[1] Revenue Act of 1918, § 337. This limitation cannot be applied to the assessment of 1917 taxes (T. B. M. 60, Treasury Bulletin 15-19-454).

[2] See Reg. 45, Art. 715. See p. 650 of the 1920 edition.

[3] Reg. 45, Art. 971. See illustration No. 7, Appendix to 1920 edition. It will be noted that the Government ruling requires the total tax to be apportioned for the purpose of applying the limitation. The statute provides that the "portion" of the tax attributable to such sale shall not exceed 20% of the selling price, and the difference be-

tween the amount of tax computed on the total income and the amount computed on the income excluding the profit on the sale seems intended by the law to be the amount which shall not exceed 20% of the selling price.

The fact that a company is entitled to the benefit of this limitation will not disqualify it for special assessment by reference to representative corporations,[4] neither can the fact that it is entitled to the benefit of the limitation be used as a basis for claiming special assessment. If a corporation falls within the class specified in the statute as being entitled to special assessment, the tax will be determined by this method. The effect of the limitation is to limit the amount of tax attributable to the profit made on the sale of mines, oil and gas wells discovered by the taxpayer and can only be applied after the tax computed on such profit has been computed without the benefit of this provision.[5]

[4] See Revenue Act of 1918, Sections 322-8.

[5] O. D. 395, Treasury Bulletin 5-20-723; T. B. M. 60, Treasury Bulletin 15-19-454.

Invested Capital.[1] "Invested capital" is the value of the capital and surplus of the taxpayer determined in accordance with rules laid down in the statute. It does not mean the par value of the issued and outstanding stock or the value of the capital stock as fixed by the Treasury Department for the purpose of the capital stock tax. It does not mean the book value of the assets, or the present net worth of the assets as shown by an appraisal or in any other manner.[2] Generally speaking, it means the amount of cash or the cash value of the property contributed to the corporation by the stockholders and the amount of earnings of the corporation which have been left in the business. Money or other property borrowed is not invested capital.[3] The cash value of the property contributed by the stockholders to the corporation may in some cases exceed the value allowed by the law for purposes of invested capital, since the restrictive rules of the statute limit the in-

[1] As to affiliated corporations see p. 708 of the 1920 edition.

[2] Reg. 45, Art. 831.

[3] Reg. 45, Art. 831.

clusion in invested capital of capital stock representing intangible property. Further, capital may be contributed to the business of a corporation in a form originally permitting its inclusion in invested capital at its full value (cash, for instance) but may lose some of its value for purposes of invested capital by being invested in stocks of other corporations (the dividends of which are not included in net income)[4] or by being invested in State, municipal or other bonds, the interest on which is exempt from income tax. In this respect the law makes an exception of bonds or other obligations of the United States, which may be included in invested capital although the interest therefrom may in some cases be excluded from gross income.[5] Surplus and undivided profits are recognized as part of invested capital, if they represent assets actually existing and owned by the corporation.

The amount of taxes withheld at the source to be later paid over to the Government is not an asset of the withholding agent and cannot be included in invested capital.[6] The surplus and undivided profits accounts may be reduced below the amounts at which they are carried on the books, if full recognition has not been given by the corporation to expenses incurred and losses sustained from the original organization down to the taxable year, including among such expenses and losses a reasonable allowance for depletion, depreciation or obsolescence of property originally acquired for cash or stock, or in any other manner. The value of the assets of the company are required in all instances to be taken as of the time of acquisition, although they may have increased in value since that date.

In a case in which the charter of a Georgia corporation expired by limitation and some time after its expiration, the fact being called to the stockholders' attention, a new corporation was organized, which new corporation issued new shares of

[4] Reg. 45, Art. 815.

[5] The purpose of permitting bonds of the United States to be included in invested capital, although the interest may be excluded in whole or in part from gross income, is to provide an incentive to invest in and hold such bonds.

[6] O. D. 202, Treasury Bulletin 9-19-350.

capital stock in exchange for all the property and assets and all the interest of the stockholders in the old company, it has been held under the Georgia statutes that for purposes of invested capital a new and distinct corporation was created, the invested capital of which should be computed accordingly.[7]

The fair market value of the assets as of March 1, 1913, has no bearing on invested capital.[8] If values have been marked up on the books of the corporation a deduction must be made in respect of such book appreciation. Full effect must also be given to any liquidation of original capital at any time prior to or during the taxable year.[9] In the case of a reorganization, consolidation or change of ownership of a trade or business after January 1, 1911, the invested capital of the predecessor for the prewar period is deemed to be the invested capital for such period of the new organization now engaged in the business.[10] In the case of a reorganization, consolidation or change of ownership of a trade or business, or change of ownership of property after March 3, 1917 (if 50% or more of the interest or control remains in the same persons), the assets so transferred will not be allowed a higher valuation in determining invested capital than under the previous ownership. If the previous owner was not a corporation, the value of the assets in the hands of the present owner will be taken at the cost to the previous owner when acquired by him.[11] The law contemplates that the invested capital shall be the average amount employed for a full year and if a corporation makes a return for a period less than twelve months the invested capital must be prorated accordingly. Thus although a corporation actually had an invested capital of $100,000 and was in existence for six months of the year 1918, for the purpose of this tax its invested capital

[7] A. R. R. 268, Treasury Bulletin 41-20-1238. See Terry v. Merchants & P. Bk., 66 Ga. 177; Logan v. W. A. R. Co., 87 Ga. 533, 13 S. E. 516; Bertram v. Collins Mfg. Co., 69 Ga. 751; Rau v. Union Paper Mill Co., 95 Ga. 208, 22 S. E. 146; Venable v. Southern Granite Co., 135 Ga. 508, 69 S. E. 822; Stearns Coal Co. v. Van Winkle, 221 Fed. 590; Pewabic Min. Co. v. Mason, 145 U. S. 349, 12 Sup. Ct. 887.

[8] Reg. 45, Art. 831.

[9] See Reg. 41, Art. 42.

[10] See p. 693 of the 1920 edition.

[11] See p. 682 of the 1920 edition for more complete statement.

would be considered as being only $50,000.[12] With respect to the value to be placed upon the several classes of assets of a corporation, such assets are divided into three classes: (1) cash paid in; (2) tangible property paid in and (3) intangible property paid in. Regardless of the character of the asset when paid in a further distinction is made with respect to the character of the asset during the taxable year. For this purpose the assets are divided into two classes: (1) admissible assets; and (2) inadmissible assets. The several classes and the adjustments required to be made with respect to each and to all as a whole are discussed in the following paragraphs.

[12] See letter from Treasury Department dated March 20, 1918; W. T. S. 1919, ¶ 764. This amounts to an assumption that if the corporation had been in business for the full year it would have earned twice the amount it did during the six months period. If it can be shown that by the very nature of its business no more income would have been earned had the corporation been in existence for the full year, it would seem that the case is one for remedial action under § 327. See p. 692 of the 1920 edition.

NO PAR VALUE STOCK. The par value of stock or shares in the case of stock or shares issued at a nominal value or having no par value is deemed to be the fair market value as of the date said stock or shares are issued.[1]

[1] Revenue Act of 1918, Section 325. The same principle has been followed under the 1917 Law (T. B. R. 38, Treasury Bulletin 11-19-390). See O. D. 348, Treasury Bulletin 30-19-644.

Cash Paid In. The amount of cash paid to a corporation in exchange for its stock is invested capital and remains such whether used for the purpose of acquiring tangible or intangible property.[1] Thus, if the stockholders of a corporation have actually and in good faith paid in cash for its stock, such cash may be used to purchase good will, patents, copyrights, trademarks or trade-brands, and the intangible assets so acquired may be included in invested capital to the extent of their cost. It is only when such intangible assets are acquired in exchange for stock that the restrictive provisions of the statute limiting the amount of intangible assets which may be included in

[1] Revenue Act of 1918, § 326 (a).

invested capital apply. If, however, the cash is used to acquire inadmissible assets, the invested capital will be reduced accordingly, since inadmissible assets reduce invested captal. But if the vendors of the property retain an interest or control of 50% or more in the property and it was transferred after March 3, 1917, the value for invested capital is limited as indicated below, whether the property is tangible or intangible.[2]

[2] See Revenue Act of 1918, § 331. See p. 682 of the 1920 edition.

STOCK SOLD AT A DISCOUNT- BROKERS' COMMISSIONS. Reasonable commissions or other forms of compensation lawfully paid by the corporation for the sale of its capital stock are not to be deducted in computing invested capital.[1]

[1] T. B. R. 4, Treasury Bulletin 11-19-391 overruling a letter from the Treasury Department dated April 14, 1919; W. T. S. 1919, paragraph 1041. This rule is a corollary of the rule that such commissions may not be deducted in computing net income.

BONUS STOCK. Capital stock issued as a bonus in connection with the sale of a corporation's bonds may not be included in invested capital unless the corporation proves to the satisfaction of the Commissioner that such stock bonus enabled the corporation to secure a higher price for the bonds than it could otherwise have secured. Whenever this fact is established, bonus stock may be included in invested capital to the extent of the difference between the selling price of the bonds and the price at which they could have been sold if issued without such stock bonus. The excess of the face value of such bonds over the price at which they could have been sold if issued without the stock bonus is deemed discount and is subject to amortization.[1]

[1] Reg. 45, Art. 832.

STOCK ISSUED FOR SERVICES. Shares of stock distributed by a corporation to its employees in payment of services rendered, where the amount is not excessive, may be included in invested capital to the extent of the actual cash value of the services rendered.[1]

[1] O. D. 248, Treasury Bulletin 13-19-431.

Tangible Property Paid In. When stock or shares have been issued for tangible property the actual cash value of the tangible property at the time it is paid in becomes invested capital.[1] If the actual cash value of such tangible property exceeds the par value of the stock issued therefor,[2] the excess over the par value may be treated as paid-in surplus, provided it is shown to the satisfaction of the Commissioner that the value of the property was clearly and substantially in excess of the par value of the stock. Evidence offered to support a claim for a paid-in surplus must be as of the date of the payment, and may consist among other things of (a) an appraisal of the property by disinterested authorities made on or about the date of the transaction; (b) certification of the assessed value in the case of real estate; and (c) proof of a market price in excess of the par value of the stock or shares. The additional value allowed in any case is confined to the value definitely known or accurately ascertainable at the time of the payment. No claim will be allowed for a paid-in surplus in a case in which the additional value has been developed or ascertained subsequently to the date on which the property was paid in to the corporation, or in respect of property which the stockholders or their agents on or shortly before the date of such payment acquired at a bargain price, as for instance, at a receiver's sale. Generally, allowable claims of this character will arise out of transactions in which there has been no substantial change of beneficial interest in the property paid in to the corporation, and in all cases the proof of value must be

[1] While the fact that a company may have defective accounting records, and can not accurately compute its invested capital, may under certain circumstances justify an assessment under section 210 of the Revenue Act of 1917, or section 328 of the Revenue Act of 1918, it does not permit valuation of assets as at a time subsequent to the date on which they were paid in for stock for computing invested capital. The assets of a corporation can not be valued as of March 1, 1913, for the purpose of computing invested capital. (T. B. M. 57, Treasury Bulletin 14-19-440.)

[2] The par value of stock or shares, in the case of stock or shares issued at a nominal value or having no par value, is deemed to be the fair market value as of the date such stock or shares are issued (Revenue Act of 1918, § 325).

clear and explicit.[3] Where a corporation is one of the parties to a contract, it cannot be held to be paid in surplus. Contracts which may be regarded as tangible assets can only constitute paid in surplus, if they were made between outside parties and the rights of either of the parties is then transferred to a corporation without adequate consideration.[4]

Where bondholders purchased at a foreclosure sale the property covered by the mortgage securing the bonds, and then transferred the property to a new corporation in exchange for its total authorized stock issue, the invested capital of the new corporation will be the value of the property as of the date of transfer to the corporation.[5]

Where a corporation exchanges its stock for the assets of a partnership, which are greatly in excess of the par value of the stock, and there is no written obligation to the partners as to the payment of the excess, the taxpayer is entitled to submit evidence in support of a claim for paid-in surplus; however, if the corporation is obligated to the partners for any portion of the excess, a claim can not be sustained.[6] The Commissioner is required to keep a record of all cases in which tangible prop-

[3] Reg. 45, Art. 836. In 1917 the rule was: Where it can be shown by evidence satisfactory to the Commissioner that tangible property has been conveyed to a corporation or partnership by gift or at a value, accurately ascertainable or definitely known as at the date of conveyance, clearly and substantially in excess of the cash or the par value of the stock or shares paid therefor, then the amount of the excess shall be deemed to be paid-in surplus. The adopted value shall not cover mineral deposits or other properties discovered or developed after the date of conveyance, but shall be confined to the value accurately ascertainable or definitely known at that time. Evidence tending to support a claim for a paid-in surplus under these circumstances must be as of the date of conveyance, and may consist, among other things, of (1) an appraisal of the property by disinterested authorities, (2) the assessed value in the case of real estate, and (3) the market price in excess of the par value of the stock or shares. (Reg. 41, Art. 63. See A. R. R. 161, Treasury Bulletin 28-20-1064.) This ruling was supported by the language of the 1917 Law (§ 207 (a)) which permitted the inclusion of "the actual cash value of tangible property paid in * * * at the time of such payment."

[4] A. R. R. 233, Treasury Bulletin 40-20-1227.

[5] T. B. R. 32. Treasury Bulletin 8-19-334.

[6] O. D. 249, Treasury Bulletin 13-19-432.

erty is included in invested capital at a value in excess of the par value of the stock issued therefor, containing (a) the name and address of the taxpayer, (b) the business in which it is engaged, (c) the amount of invested capital and net income shown by the return, (d) the value of the tangible property at the time it was paid in, (e) the par value of the stock specifically issued therefor, and (f) the amount included as paid-in surplus. He is also required to furnish a copy of such record and other detailed information with respect to such cases when required by resolution of either House of Congress without regard to the restrictions ordinarily imposed on him with respect to making public the contents of tax returns.[7]

[7] Revenue Act of 1918, § 326 (a).

Definition of Tangible Property. The term "tangible property" means stocks, bonds, notes and other evidences of indebtedness, bills and accounts receivable, leaseholds, and other property other than intangible property.[1] A contract may be treated as tangible property only after the submission of a full statement as to its exact nature showing to the satisfaction of the Commissioner that it relates to rights in tangible property to such an extent that its value arises chiefly therefrom.[2]

[1] Revenue Act of 1918, § 325 (a). The 1917 Law contained no definition of intangible property, but the Treasury Department held that the term included stocks, bonds, bills and accounts receivable, notes and other evidence of indebtedness and leaseholds. (Reg. 41, Art. 47.)

[2] Reg. 45, Art. 811.

EVIDENCES OF INDEBTEDNESS. Enforceable notes or other evidences of indebtedness, either interest bearing or non-interest bearing, of the subscriber received by a corporation upon a subscription for stock may be considered as tangible property in computing its invested capital to the extent of the actual cash value of such notes or other evidences of indebtedness at the time when paid in, but only (a) if such notes or evidences of indebtedness could under the laws of the jurisdiction in which the corporation was organized legally be received in payment for stock, and (b) if they were actually received by the corporation as absolute, and not as conditional, payment in

whole or in part of the stock subscription.[1] Notes received from employees in payment of stock, title to which will revert to the corporation if the employee severs his connection with the corporation and to be paid out of earnings accruing on stock for which they are ostensibly given, while tangible property in a strict sense, add nothing to the resources of the. corporation and are not "*bona fide* paid in" within the meaning of the statute. Even if an increase in working capital were achieved by the discounting of or borrowing on such notes, such increased capital would constitute borrowed capital which may not be included in invested capital.[2] Stock subscribed for by employees under an agreement permitting payments in cash, part cash and part deferred payments, or all deferred payments, subject to conditions that payment of subscriptions should be in weekly installments; that deferred payment should bear interest; and that the agreement might be canceled either upon request of the employee, failure to make payments, any attempt of the purchaser to sell his stock or agreement ,or resignation or dismissal of the employee prior to the expiration of five years; in the event of any cancellation the employee to receive the full amount of all payments with interest, and, dependent upon the time held more than one year, certain percentages of the difference between the subscription and market price of the stock; dividends to be credited to the subscriber's account as additional payments, except in case of cancellation, in which case the subscriber incurs no charge for interest upon deferred payments may be recognized as invested capital only in so far as the subscription payments have been actually received by the company.[3]

[1] Reg. 45, Art. 833.
[2] S. 1391, Treasury Bulletin 22-20-980.
[3] A. R. R. 10, Treasury Bulletin 1-20-664.

VALUE OF PROPERTY AS OF JANUARY 1, 1914. Under the 1917 Law the value of tangible property as of January 1, 1914, could be taken in the case where such property had been paid in for stock or shares prior to that date, but not in excess of the par value of the stock or shares. No such provision ap-

pears in the 1918 Law and the value must in all cases be determined as of the time of acquisition.[1]

[1] Cf. Revenue Act of 1917, § 207 and Revenue Act of 1918, § 326; O. D. 89, Treasury Bulletin 1-19-128.

Intangible Property. The term "intangible property" means patents, copyrights, secret processes and formulæ, good will, trade-marks, trade-brands, franchises and other like property.[1] Most contracts are intangible property and in the absence of a specific ruling by the Commissioner to the contrary should be so regarded for the purpose of making returns. Contracts relating to or representing rights in tangible property are regarded as tangible property[2] but only if *bona fide* paid in for stock or shares.[3] An unperformed contract to furnish manufactured products represents no rights in tangible property which would entitle it to be regarded as deriving its value chiefly therefrom. On the contrary, the value of the contract is of an intangible nature, contingent upon the performance of its terms and the realization of the anticipated profit.[4] Associated Press, and similar franchises, and subscription lists and mailing lists are intangible property.[5] The actual cash value of intangible property paid in for stock or shares must be determined in the light of the facts in each case. Among the factors to be considered are (a) the earnings attributable to such intangible assets while in the hands of the predecessor

[1] Revenue Act of 1918, § 325 (a); A. R. R. 29, Treasury Bulletin 9-20-776. In the 1917 Law patents were not defined as intangible property. (Revenue Act of 1917, § 207.) Under the 1917 Law the term "other intangible property" as used in § 207 was construed to mean property of a character similar to good will, trade marks and the other specific kinds of property enumerated in the same clause. Property not clearly of such character might be held to be tangible within the meaning of the law. (Reg. 41, Art. 47.) Patents had a status intermediate between tangible and intangible property. (T. B. M. 17, Treasury Bulletin 3-19-208.)

[2] Reg. 45, Art. 811.

[3] O. D. 306, Treasury Bulletin 24-19-578.

[4] O. D. 635, Treasury Bulletin 33-20-1140. In the case stated in this decision there would seem to have been a mixed aggregate of tangible and intangible property within the meaning of Section 327.

[5] Reg. 45, Art. 811.

owner; (b) the earnings of the corporation attributable to the intangible assets after the date of their acquisition; (c) representative sales of the stock of the corporation at or about the date of the acquisition of the intangible assets; and (d) any cash offers for the purchase of the business, including the intangible property, at or about the time of its acquisition. A corporation claiming a value for intangible property paid in for stock or shares should file with its return a full statement of the facts relating to such valuation.[6]

It has been held that where a corporation controlled by a few individuals uses part of its profits to pay notes of its principal stockholders previously given as part of the purchase price of the stock of retiring stockholders, the amount of which notes being equal to the excess of the agreed price of such stock over its par or book value, such is not payment made *bona fide* specifically as such in cash or tangible property for good will or other intangible property, even though the retiring stockholders had in the contract of sale of stock agreed to refrain from entering into the business conducted by the corporation for a specified number of years.[7] In cases where stock has been issued for intangible property the following rules apply:

[6] See Reg. 45, Art. 851.

[7] In its recommendation the committee referred to the definitions of the term goodwill contained in the following cases: Boon v. Moss, 70 N. Y. 465; Lane v. Smythe, 46 N. J. Eq. 443, 19 Atl. 199; Crutwell v. Lye, 17 Ves. Jr. 335; Dodge Stationery Co. v. Dodge, 145 Cal. 380, 78 Pac. 879.

INTANGIBLE PROPERTY PAID IN PRIOR TO MARCH 3, 1917. Where intangible property was paid in prior to March 3, 1917, such intangible property becomes invested capital in an amount not exceeding (a) the actual cash value of the property at the time paid in, (b) the par value of the stock or shares issued therefor[1] or (c) in the aggregate 25% of the par value of the total stock or shares of the corporation outstanding on March

[1] The par value of stock or shares in the case of stock or shares issued at a nominal value or having no par value, is deemed to be the fair market value as of the date such stock or shares are issued. (Revenue Act of 1918, § 325.)

3, 1917,[2] whichever is the lowest.[3] Illustration: assume the par value of the capital stock of a corporation issued and outstanding on February 1, 1917, was $100,000. On February 2, 1917, it issued an additional $100,000 par value of stock for intangible property having a cash value of $100,000. Applying the foregoing rule, (a) equals $100,000; (b) equals $100,000 and (c) equals 25% of $200,000 (the par value of the stock outstanding on March 3, 1917). Therefore (c), or $50,000, is all that may be considered as invested capital representing such intangible property. A further limitation on the inclusion in invested capital of capital stock representing intangible property paid in both before and after March 3, 1917, is discussed in a later paragraph.[4]

[2] Under the 1917 Law it was held that tangible property *bona fide* purchased prior to March 3, 1917, with stock having no par value could be included in invested capital at a value not exceeding the actual cash value of such intangible property at the time of the purchase or in an amount not exceeding 20% of the total shares of stock outstanding on March 3, 1917, measured by their value as at the date or dates of issue. (Reg. 41, Art. 58.)

[3] Revenue Act of 1918, § 326 (a) 4, 5. In the case of a reorganization in which the capital stock is increased but the control of the business remains in the same hands the value of the stock issued for intangible property must be determined with reference to the capitalization of the old company and not the capitalization of the new company. (Letter from Treasury Department dated March 14, 1918.)

[4] See p. 663 of the 1920 edition.

INTANGIBLE PROPERTY PAID IN ON OR AFTER MARCH 3, 1917. Where the intangible property was paid in after March 3, 1917, such intangible property becomes invested capital in an amount not exceeding (a) the actual cash value of the property at the time paid in, (b) the par value of the stock or shares issued therefor, or (c) 25% of the par value of the total stock or shares of the corporation outstanding at the beginning of the taxable year, whichever is lowest. Illustration: assume a corporation has $200,000 par value of capital stock outstanding on December 30, 1917. On December 31, 1917, it issues an additional $100,000 of capital stock for intangible property having a cash value of $100,000. Applying the foregoing rule: (a) equals $100,000; (b) equals $100,000; and for the taxable

year 1918 (c) equals 25% of $300,000. Therefore the invested capital representing such intangible property is $75,000. But if the same intangible property had been acquired on January 2, 1918, instead of December 31, 1917, the invested capital for 1918 representing the same value of intangible property would be only $50,000 instead of $75,000, since in that case the par value of the capital stock outstanding at the beginning of the taxable year would have been only $200,000.[1] A further limitation on the inclusion in invested capital of capital stock representing intangible property paid in both before and after March 3, 1917, is discussed in the following paragraph.

[1] Revenue Act of 1918, § 326 (a) 4, 5.

WHERE INTANGIBLE PROPERTY HAS BEEN PAID IN BOTH BEFORE AND AFTER MARCH 3, 1917. Where intangible property has been paid into a corporation before and also after March 3, 1917, a further limitation is imposed upon the value of the invested capital to represent in the aggregate all such intangible property. The law provides that in no case shall the total amount of invested capital representing intangible property paid in both before and after that date exceed in the aggregate 25% of the par value of the total stock or shares of the corporation outstanding at the beginning of the taxable year.[1] Illustration: assume the par value of the capital stock outstanding February 1, 1917, was $100,000 and that $100,000 additional was issued for intangible property of the same cash value on February 2, 1917, and a further issue of $100,000 par value on December 31, 1917, for intangible property also having an equal cash value. Applying the first and second rules stated in the preceding paragraphs it is found that the invested capital with respect to the first intangible property is $50,000 and with respect to the second intangible property is $75,000, making the total for both $125,000. But applying the third rule the total invested capital representing both the property acquired on February 2, 1917, and that acquired on December 31, 1917, is reduced in the aggregate to $75,000. If the second property had been acquired on January 2, 1918, instead of

[1] Revenue Act of 1918, § 326 (a) 5.

December 31, 1917, the invested capital representing both properties would be reduced even lower, namely to $50,000, which amount would then represent 25% of the par value of the capital stock of the corporation outstanding January 1, 1918.[2]

[2] As to affiliated corporations see p. 708 of the 1920 edition.

STOCK OR SHARES OUTSTANDING ON MARCH 3, 1917. Where since the organization of a corporation its capital stock has been increased or reduced and such change represents an actual acquisition of new property for stock or an actual impairment of original properties, the 25% limitation will be based on the par value of the total stock outstanding on March 3, 1917.[1]

[1] T. B. M. 5, Treasury Bulletin 1-19-120.

NO PAID-IN SURPLUS AS TO INTANGIBLE PROPERTY. No paid-in surplus may be included in invested capital by reason of any excess in the actual value of intangible property at the date of acquisition over the par value of the stock or shares issued therefor. On the contrary, such intangible property is subject to the 25% limitation stated in the preceding paragraphs, whatever its actual value may be.[1]

[1] A. R. M. 80, Treasury Bulletin 37-20-1196; A. R. R. 307, Treasury Bulletin 44-20-1282.

Mixed Aggregates of Tangible and Intangible Property. The Revenue Act of 1918[1] provides that where a mixed aggregate of tangible property and intangible property has been paid in for stock or for stock and bonds and the Commissioner is unable satisfactorily to determine the respective values of the several classes of property at the time of payment, or to distinguish the classes of property paid in for stock and for bonds, respectively, the corporation shall be assessed by reference to representative corporations engaged in a like or similar trade or business.[2] Where stock or shares and bonds or other obliga-

[1] Revenue Act of 1918, § 327 (c).
[2] See Revenue Act of 1918, § 328.

tions have been issued for a mixed aggregate of tangible and intangible property, it will be presumed in the absence of satisfactory evidence to the contrary that the bonds were issued for tangible property and that the stock was issued for the balance of the tangible property, if any, and for the intangible property. Where stock or shares have been issued for a mixed aggregate of tangible and intangible property and certain liabilities have been assumed in connection with the transaction, it will be presumed that such liabilities are to be charged against the tangible property and the intangible property in the order named, unless it is shown by evidence satisfactory to the Commissioner that this presumption is not in accordance with the facts.[3] Where a mixed aggregate of tangible and intangible property is acquired for stock and no provision is made that the intangibles shall be specifically paid for as such, in order that such intangibles may be included in invested capital it is only necessary to show the relative values of the

[3] Reg. 45, Art. 835. Under the 1917 Law it was held that where stock or shares (or stock or shares and bonds or other obligations) have been issued for a mixed aggregate of: (a) Tangible property, (b) Patents and copyrights, and (c) Good will or other intangible property, the following rules would govern. (1) In the absence of satisfactory evidence to the contrary, it was presumed in the case of a corporation, that its stock was issued for the following purposes in the order named: (a) Good will or other intangible propery, (b) Patents and copyrights, and (c) Tangible property. (2) Upon the production by the taxpayer of evidence satisfactory to the Commissioner as to the actual values at the date of acquisition of (a) the tangible property and (b) the patents and copyrights, the sum of these two items could be applied against the total par value of the securities issued and the remainder was then deemed to represent the par value of the securities issued for the good will or other intangible property. (3) Cases where mixed aggregates of tangible and intangible property have been paid in for stock and bonds were, if the Secretary was unable to determine satisfactorily the respective values of the several classes of property at the time of payment, treated as coming under the head of cases where the invested capital could not be satisfactorily ascertained and the tax was assessed accordingly. (Reg. 41, Art. 59.) T. B. R. 49, Treasury Bulletin 16-19-467.

tangibles and intangibles for which stock was issued, subject to the 20 or 25% limitation.[4]

[4] A. R. M. 80, Treasury Bulletin 37-20-1196. See A. R. R. 307, Treasury Bulletin 44-20-1282.

SURPLUS AND UNDIVIDED PROFITS OF FOREIGN BRANCH OFFICE. In order to determine the amount of surplus attributable to a foreign branch office the amounts remitted by it to the home office should be taken into earned surplus at their value in American currency at the time of the remittances and the balance of the net profits of the branch office not remitted to the home office should be converted into American currency at the rate of exchange as at the end of the taxable year.[1]

[1] O. D. 618, Treasury Bulletin 31-20-1109; O. D. 550, Treasury Bulletin 25-20-1009.

Surplus and Undivided Profits. Paid-in or earned surplus and undivided profits at the beginning of the taxable year may be included as invested capital. Surplus and undivided profits earned during the year may not be included.[1] Appreciation in values due to reappraisement cannot be regarded as paid-in or

[1] Revenue Act of 1918, § 326 (a). Under the 1917 Law some doubt existed as to whether or not surplus earned during the taxable year and actually employed in the business during a part of that year could not be included in invested capital. The Treasury Department ruled that it could not in the case of corporations and partnerships (Reg. 41, Art. 61) even though invested in bonds of the United States (T. D. 2541) or set up as "surplus" on the books or distributed in the form of stock dividends (Reg. 41, Art. 61) but that profits earned during the year could be included as invested capital of individuals (Id. Art. 69). The 1917 Law also provided that surplus or undivided profits in order to be included in invested capital should be "used or employed in the business," but the distinction, if any exists, between assets used and assets not used in the business of a corporation was too fine for practical purposes, and since the law elsewhere provided that all the income of a corporation should be deemed to be received from its trade or business, the Treasury Department ruled that all surplus or undivided profits would be deemed to be employed in the business, unless invested in inadmissible assets (Id. Art. 62).

earned surplus,[2] even though income tax has been erroneously paid thereon.[3]

[2] A. R. R. 29. Treasury Bulletin 9-20-776; A. R. R. 71, Treasury Bulletin 18-20-906; Letter from Treasury Department dated March 5, 1918.

[3] T. B. M. 41, Treasury Bulletin 7-19-308.

REPLACEMENT FUND. So much of a replacement fund for steamers lost as represents excess of the amount of insurance received over the book value of the steamers at the time of their destruction may not be included in invested capital for the purpose of war and excess-profits taxes, even though the interest received from the investment of such excess is reported as taxable income, because such excess is not "paid-in or earned surplus."[1]

[1] O. D. 417, Treasury Bulletin 12-20-801. See also Reg. 45, Art. 50, and a discussion of replacement funds in Chapter 20.

PAID-IN SURPLUS. Where it is shown by evidence satisfactory to the Commissioner that tangible property has been paid in by a stockholder[1] to a corporation as a gift or at a value definitely known or accurately ascertainable as of the

[1] The property must be paid in *by* a stockholder. A claim for paid-in surplus will not be allowed in the case of the appreciated value of a leasehold acquired by a company as original lessee without cost and which was not paid in at a fixed value for stock or shares (A. R. R. 86, Treasury Bulletin 19-20-925). In a case arising under the 1917 Law two stockholders owning most of the stock of a company invented certain machinery for which patents were issued to them. The company paid the cost of the patents and used them as though it owned them without compensation to the inventors. In 1916 the patents were put upon the books of the company at a certain value and a stock dividend was declared. The Committee on Appeals and Review held that, even assuming the patents not to have been formally assigned to the company until 1916, they were not paid for by the issuance of stock or by any payment of cash, for which reason the amount placed upon the corporate books as the value of the patents could not be included in invested capital (A. R. R. 9, Treasury Bulletin 1-20-665). It is difficult to see why such patents should not be included in invested capital as paid-in surplus on the theory that they constitute tangible property (under the 1917 Law) paid in by stockholders as a gift. The stock dividend, in such event, merely capitalizes the paid-in surplus.

date of such payment clearly and substantially in excess of the cash or other consideration paid by the corporation therefor, then the amount of the excess will be deemed to be paid-in surplus. Substantially the same kind of evidence will be required to show the value in this case as is required in the case of tangible property paid in at a value greater than the par value of the shares issued therefor.[2]

[2] Reg. 45. Art. 837.

OIL LEASES INFORMALLY TRANSFERRED TO CORPORATION. It is held that where certain commercial leases of oil lands are informally transferred to a corporation formed by the lessees for the purpose of taking over such leases, no consideration being paid for such transfer, it will be deemed that the transfer was made at the time of taking possession, and the addition to invested capital of the corporation upon such transfer is the fair market price or value of the leases at the time possession is so taken by the corporation.[1]

[1] S. 1387, Treasury Bulletin 21-20-965.

EARNED SURPLUS. Only true earned surplus and undivided profits can be included in the computation of invested capital, and if for any reason the books do not properly reflect the true surplus such adjustments must be made as are necessary in order to arrive at the correct amount. Any portion of surplus or undivided profits representing unearned interest or discount which has not been reported as taxable income must be excluded in the computation of invested capital for war profits and excess profits purposes.[1] In the computation of earned surplus and undivided profits full recognition must first be given to all expenses incurred and losses sustained from the original organization of the corporation down to the taxable year, including among such expenses and losses reasonable allowances for depreciation, obsolescence, or depletion of property (irrespective of the manner in which such property was originally acquired), and for the amortization of any discount

[1] O. D. 91, Treasury Bulletin 1-19-130.

on its bonds. There can of course be no earned surplus or undivided profits until any deficit or impairment of paid-in capital due to depletion, depreciation, expense, losses, or any other cause has been made good. Where adequate evidence is presented that the amounts written off or deducted in previous returns of net income are in the aggregate incorrect or unreasonable, adjustments must be made, and the taxpayer will be allowed a refund in respect of any taxes overpaid in prior years, or in the case of an underpayment of taxes will be additionally assessed[2]. Unrealized appreciation in the value of assets cannot be taken into consideration for the purpose of offsetting a decrease by reason of depreciation, obsolescence or depletion.[3] Depletion, like depreciation, must be recognized in all cases in which it occurs. Depletion attaches to each unit of mineral or other property removed, and the denial of a deduction in computing net income under the Act of August 5, 1909, or the limitation upon the amount of the deduction allowed under the Act of October 3, 1913, does not relieve the corporation of its obligation to make proper provision for depletion of its property in computing its surplus and undivided profits. Adjustments in respect of depreciation or depletion in prior years will be made or permitted only upon the basis of affirmative evidence that as at the beginning of the taxable year the amount of depreciation or depletion written off in prior years was insufficient or excessive, as the case may be. Where deductions for depreciation or depletion have either on the books of the corporation or in its returns of net income been included in the past in expense or other accounts, rather than specifically as depreciation or depletion, or where capital expenditures have been charged to expense in lieu of depreciation or depletion, a statement indicating the extent to which this practice has been carried should accompany the return.[4]

[2] Reg. 45, Art. 838.
[3] A. R. R. 71, Treasury Bulletin 18-20-906.
[4] Reg. 45, Art. 839.

INFORMAL DIVIDENDS; CREDIT BALANCES TO STOCKHOLDERS' ACCOUNTS. Where a corporation notes and credits to its

stockholders their *proportionate* shares of each year's earnings to which they would be entitled under a dividend declaration, and such stockholders return such credited earnings and pay income tax thereon, but no interest is paid upon the amounts standing to the credit of the stockholders and no formal dividend declaration is made by the board of directors, the amounts so credited may be regarded as a part of earned surplus, provided that under the State law the stockholders do not rank with general creditors in respect of such credits.[1] But in a case arising under the 1917 Law [2] very similar in its facts except that the balances standing to the credit of the stockholders were not in proportion to their stockholdings a different conclusion was reached. The corporation involved had three stockholders. During the lifetime of these stockholders no distribution of profits was made and the earnings were allowed to accumulate from year to year. At the death of one stockholder, in 1907, the board of directors passed a resolution ordering the reserve fund to be prorated and credited to the deposit accounts of the three principal stockholders, which was done. None of these profits was withdrawn; the business proceeded as before and the profits were allowed again to accumulate until 1909, when a second stockholder died, and the same procedure was taken as in 1907. From the inception of the business no dividend was ever declared nor were any of the profits withdrawn from the business or segregated from surplus except as above stated; but against the accounts credited comparatively small charges were made from time to time to cover living expenses of two of the stockholders. Substantially all of the profits thus credited, by verbal agreement were left in the corporation funds for the conduct of its business; on the amounts so credited no interest was ever paid by the corporation nor were notes issued therefor, for the reason that they were never considered as obligations of the corporation; but, on the contrary, as funds left in the business to be used as capi-

[1] A. R. M. 71, Treasury Bulletin 29-20-1081.

[2] The 1917 and 1918 Laws are not distinguishable in their provisions governing the point.

tal; and banks and other large creditors of the corporation were cognizant of this verbal agreement, and by reason of it extended credit to the corporation on these funds considered as capital. It was admitted that the credits were not "surplus" in the sense that all the stockholders had a right to share in them ratably. The Committee on Appeals and Review ruled that the credits ranked, in law, with the claims of other general creditors; even though by the good faith and honor of the three stockholders, they would be voluntarily deferred until the claims of the other general creditors had been liquidated in full and that the corporation was not being penalized merely because of its failure to have made a "book entry" converting these credits into capital stock because the credits, being a direct and fixed obligation of the corporation, had not the same status among the corporation's liabilities as would have been the case had they, by formal action of the board, been converted into capital stock and certificates issued therefor, or had the interested stockholders waived all proprietary rights to them and thus actually contributed them to surplus.[3]

[3] A. R. R. 102, Treasury Bulletin 21-20-963.

INSTALLMENT SALES. If a taxpayer reports profits on installment sales on the basis of the proportionate part of each installment received representing profit, his surplus account as at the beginning of the taxable year must be reduced in computing invested capital to the extent that the surplus account includes profit on such sales which has not been reported as taxable income.[1]

[1] O. D. 92, Treasury Bulletin 1-19-131.

PURCHASE OF STOCK WITH CASH AND PATENTS. Where a domestic corporation exchanges patent rights and cash for stock in a foreign corporation which derives no income from sources within the United States, the shares of stock so received constitute admissible assets. Such stock is to be valued in determining the invested capital of the domestic corporation at the amount of cash paid therefor plus the value of the pat-

ent rights at the time of the purchase, such value not to be taken as exceeding the value of the shares of stock received in exchange for the patent rights. The effect of the transaction may be to increase or decrease the surplus and undivided profits of the domestic corporation though the cash and patent rights remain the same. Such increase or decrease is due to such a change in the situation as amounts to a realization of gain or loss. Any gain so realized is earned surplus as any loss so realized effects a decrease in earned surplus. In determining invested capital, earned surplus is considered regardless of the time when earned, and it is therefore immaterial that the gain or loss realized from the transaction was due to appreciation or depreciation which in part occurred prior to March 1, 1913. In this respect the principles applicable to the determination of invested capital differ from those applicable to the computation of taxable income, for while such part of the realized appreciation, if any, as is attributable to the period after March 1, 1913, constitutes taxable income such part as is attributable to the period before March 1, 1913, though considered in the computation of invested capital, escapes taxation.[1]

[1] T. B. R. 67, Treasury Bulletin 22-19-538.

Reserves. The amounts shown on the balance sheet as reserves may or may not be included as invested capital depending upon the character of the reserve.[1] Some reserves are

[1] "Reserves" have been variously classified by accountants. They are classified by Mr. Esquerré in "Applied Theory of Accounts" as follows: "1. Reserves for Depreciation; 2. Operating Reserves; 3. Reserves for Surplus Contingencies; 4. Reserves for Redemption of Debt; 5. Secret Reserves; and 6. Reserves for Exhaustion of Physical Assets." Reserves are classified by Mr. Hatfield in "Modern Accounting" as follows: "1. Reserves created to provide a permanent increase of capital. (a) As an additional guaranty to creditors. (b) To provide for extension of its fixed or other assets. 2. Reserves created to provide an additional capital which can be used to cover unusual losses or to provide for other emergencies without encroaching on the nominal capital. 3. Reserves created to provide for equalizing dividends by retaining part of one year's profit to be used to make up scanty profits for other years."

merely subdivisions of the surplus account and are true surplus or undivided profits. Such reserves are, for instance, reserves for bad debts, reserves for contingencies, reserves for self-insurance, and reserves for Federal income and excess-profits tax. Any reserve the additions to which cannot be deducted as an expense in the return of income, may be considered as a part of the surplus and undivided profits for the purpose of invested capital. On the other hand, with perhaps only two exceptions, reserves, the additions to which may be deducted in ascertaining net income, cannot be included as invested capital. Among such reserves are reserves for depreciation (which are presumed to offset the loss in the assets) and reserves for state or local taxes in cases where the corporation reports on an accrual basis and the amounts carried to such reserves have been deducted. An exception to this general rule would appear to exist in the case of reserves for depreciation or depletion based upon the value of the property as of March 1, 1913, or in the case of depletion based on the value of a mine or oil or gas property thirty days after discovery. These exceptional cases are referred to in the following paragraphs.

RESERVES FOR TAXES. Reserves set aside out of surplus or undivided profits of preceding years for payment of Federal taxes or state taxes not yet due can be included in invested capital for the taxable year if, and to the extent that, such taxes were not allowable deductions in computing net income for the preceding taxable years. Inasmuch as Federal income and excess-profits taxes are not deductible in computing net income subject to such taxes, reserves set aside for the payment of such taxes may be included in invested capital.[1] But amounts payable on account of income and excess-profits taxes for any year may be included in computing the surplus and undivided profits for the succeeding year only for the proportionate part of the year represented by the period of time between the close of the taxable year and the date or dates on which such taxes

[1] Letter from Treasury Department dated March 20, 1918; W. T. S. 1918, ¶ 911.

become due and payable.[2] A deduction from the invested capital as of the beginning of the taxable year must therefore be made for such taxes or any installment thereof, averaged for the proportionate part of the taxable year after the date when the tax or the installment is due and payable. Where as a result of an audit by the Commissioner, or the acceptance of an amended return, or for any other reason, the amount of any such tax for the preceding year is subsequently changed, a corresponding adjustment will be made in the invested capital for the taxable year upon the same basis as if the corrected amount of the tax for the preceding year had been used in the original computation of the invested capital for the taxable year.[3]

[2] Reg. 45, Art. 845; T. D. 2791. Prior to this Treasury Decision it was uncertain whether or not a corporation which indicated on its books of account that the excess-profits tax imposed on the income for 1917 was paid out of the earnings of 1918 need reduce its invested capital by reason of such payments. It was argued that the corporation had the option of paying the tax from either the income of 1917 or the income of 1918. This ruling is intended to apply a uniform rule in all cases regardless of whether or not the corporation set up a part of its surplus as reserves for Federal taxes.

[3] Reg. 45, Art. 845.

RESERVE FOR DEPRECIATION OR DEPLETION. If any reserves for depreciation or for depletion are included in the surplus account it should be analyzed so as to separate such reserves and leave only *real surplus*. Reserves for depreciation or depletion can not be included in the computation of invested capital, except to the following extent: (1) Excessive depletion or depreciation included therein and which if charged off could be restored may be included in the computation of invested capital[1] and (2) where depreciation or depletion is computed on the value as of March 1, 1913, or as of any subsequent date, the proportion of depreciation or depletion representing the realization of appreciation of value at March 1, 1913, or such subsequent date, may if undistributed and used or employed in the business be treated as surplus and included in the computation of invested capital. For the purpose of computing in-

[1] See Reg. 45, Art. 840.

vested capital, depreciation or depletion computed on the value as of March 1, 1913, or as of any subsequent date must, if such value exceeded cost, be deemed a pro rata realization of cost and appreciation and be apportioned accordingly. Except as above provided value appreciation (even though evidenced by an appraisal) which has not been actually realized and, in respect of amounts accrued since March 1, 1913, reported as income for the purpose of the income tax can not be included in the computation of invested capital, and if already reflected in the surplus account it must be deducted therefrom.[2]

[2] Reg. 45, Art. 844.

Patents. From the standpoint of assets a patent, or more particularly a group of patents, is closely analogous to good will. Their value is contingent upon and measured by their earning power. While patents have a definite life there is a common tendency to extend that life by improvements upon the original, and in a successful business the patent value merges more or less completely into a trade name or other form of good will. Therefore, while deductions in respect to the depreciation of patents based upon a normal life period of seventeen years are allowable in computing net income for the purpose of the income tax, such deductions are not obligatory, but are optional with each taxpayer. Where since January 1, 1909, a corporation has exercised that option to its own benefit in computing its taxable net income the amount so deducted can not now be restored in computing invested capital.[1] Thus, a corporation owning patents covering certain inventions made by its employees, the cost of securing and the salaries of such employees being paid by the corporation and charged to expense account, may not include in its invested capital any amount representing either the cost of the patents or appreciation in their value.[2] Where, however, the cost of patents has been charged against surplus or otherwise disposed of in such a manner as not to benefit the corporation in computing its tax-

[1] Reg. 45, Art. 843.
[2] A. R. R. 71, Treasury Bulletin 18-20-906.

able net income since January 1, 1909, any amount so written off may be restored in computing invested capital, if it be shown to the satisfaction of the Commissioner that the amount so written off represented a mere book entry ascribable to a conservative policy of management or accounting and did not represent a realized shrinkage in the value of such assets. Any amount so restored may not be written off by way of deductions from taxable net income in any subsequent year or years. Where a corporation has charged to current expenses the cost of developing or protecting patents, no amount in respect thereof expended since January 1, 1909, can be restored in computing invested capital. In respect of expenditures made before January 1, 1909, a corporation now seeking to restore them must be prepared to show to the satisfaction of the Commissioner that all such items are proper capital expenditures. It can not be said that the correct computation of surplus and undivided profits necessarily requires a deduction in respect of the expiration of patents. It follows, therefore, that where a corporation in the exercise of its option has not written down the cost of patents, it is not ordinarily necessary to reduce the surplus and undivided profits in computing invested capital, whether the patents have been acquired for stock or shares or for cash or other tangible property. Due consideration will be given to the facts in any case in which this rule seems obviously unreasonable.[3]

[3] Reg. 45, Art. 843.

Property Taken for Debt. Real or personal property taken by a corporation in payment or satisfaction of a debt, or property received in exchange for other property, will be an admissible asset at its fair market value upon receipt. The profit or loss, if any, resulting from the transaction will not be reflected in invested capital until the succeeding taxable year.[1]

[1] Reg. 45, Art. 847.

Discount on Sale of Bonds. Discount allowed on the sale of bonds is in effect an advance on account of interest, so that the

effective rate of interest in such a case is equal to the sum of the nominal rate plus the rate necessary to amortize the discount over the life of the bonds. Where, under incorrect accounting practices, the discount on bonds has been charged to a property account or otherwise carried as an asset, and is so reflected in the surplus account, it is necessary in computing invested capital to make an adjustment in respect of such discount.[1]

[1] Reg. 45, Art. 848.

Bank Discount. Only the amount of discount which has actually been reported by a bank in a prior year as taxable income and credited to surplus account may be included in surplus as of the beginning of the taxable year.[1]

[1] Reg. 45, Art. 849.

Current Profits. Profits earned during any year can not be included in the computation of invested capital for that year, even though during the year such profits are set up as surplus on the books or assumed to be distributed in the form of stock dividends. If a dividend is declared and paid during any year out of the profits of that year and the stockholders pay back into the corporation all or a substantial part of the amount of such dividends, the amount so paid back can not be included in the computation of invested capital unless the corporation shows by evidence satisfactory to the Commissioner that the dividends were paid in good faith and without any understanding, express or implied, that they were to be paid back.[1]

[1] Reg. 45, Art. 850.

Surrender Value of Insurance Policies. Premiums paid by a corporation for insurance on the lives of its officers and employees payable to it cannot be deducted as expenses in computing taxable income. Such insurance policies are considered tangible property and may be included as invested capital of the corporation at their cash surrender value at the beginning of the taxable year. The whole amount of premiums paid on

such insurance can not be included in surplus, but the surplus will be considered as increased as of the beginning of each taxable year by the amount added to the cash surrender value of the policy.[1] The cash surrender value of a life insurance policy which constitutes surplus as at the beginning of the taxable year for invested capital purposes retains its character as surplus, even though the policy constituting the admissible asset upon the basis of which the surplus was determined is terminated and paid.[2]

[1] Reg. 45, Art. 846; A. R. R. 229, Treasury Bulletin 41-20-1239.

[2] O. D. 179, Treasury Bulletin 7-19-309.

Additions to Surplus Account. A corporation's books of account will be presumed to show the facts. If it claims that its capital or surplus account is understated the burden of proof will rest upon it. Additions to such accounts will be accepted to the following extent: (1) Excessive depreciation heretofore charged off on property still owned and in use, if it is now shown by satisfactory proof to have been excessive and such excess is substantial in amount, whether or not disallowed by the Commissioner as a deduction from gross income, may be restored to the surplus account. No such amount may be restored, however, unless it is shown that adequate depreciation has been deducted upon all other property of the corporation still in use, nor in any case in which such amount has been allowed as a deduction for amortization[1] or in which the cost of the property has been recovered through being included in the price of goods or services, as for example, in the case of patterns, dies, plates, special tools, etc., or under a munition contract with a foreign government; (2) Amounts which have been expended before January 1, 1917, for the acquisition of plant, equipment, tools, patterns, furniture, fixtures or like tangible property, having a useful life extending substantially beyond the year in which the expenditure was made, and which have been charged as current expense, may (less proper deductions for depreciation or obsolescence) be added to the sur-

[1] See Revenue Act of 1918, § 234 (a) 8.

plus account when such assets are still owned and in active use by the corporation during the taxable year. Special tools, patterns, and similar assets will not be assigned any value if their cost has been recovered through having been included in the price of goods. If their cost has not been so recovered and they are held for only occasional use, they will not be assigned a value in excess of the fair value based upon the earnings actually arising from their current use, and in no case will such value be more than the cost less depreciation. Assets of this kind not in current use will not be valued at more than their nominal or scrap value. (3) Amounts which have been expended in the past for intangible property of any kind can be restored to capital or surplus account only to the extent that the corporation specifically paid such amounts for the intangible property as such.[2] (4) Adjustments necessary to correct other errors found in the books of account may be made.[3]

[2] It was also held under the 1917 Law that although large sums may have been spent in advertising and thereby an extensive good will may have been created, the sums so spent could not be considered as amounts paid for good will if the amounts were charged to general expense from time to time. Good will could be included only when bought and paid for specifically as such. (Letter from Treasury Department dated March 5, 1918.)

[3] Reg. 45, Art. 840; See T. B. R. 6. Treasury Bulletin 2-19-151.

Limitation of Additions to Surplus. Additions to surplus which a corporation may desire to make under the preceding paragraph fall broadly into 2 classes: (1) To correct returns of income for prior years in which actual errors have been made, as for example where excessive depreciation has been deducted, additions to plant and equipment or other capital charges have been charged off as an expense, inventories have been taken upon a wrong basis of valuation, etc.; (2) To reinstate in surplus deductions from income which are as a matter of good accounting to some extent optional, such as experimental expenses, patent litigation, development of good will through advertising or otherwise, etc. Adjustments falling in class (1) will be permitted for all years, whether before or

after March 1, 1913, provided amended returns of income are filed for each year in which an erroneous return has been made. Due consideration will be given to the assessment of penalties in any case in which a fraudulent return has been made. Adjustments falling in class (2) cannot be permitted, as in such cases it is considered that the corporation has exercised a binding option in deducting such expenses from income. An election of this sort which was made concurrently with the transaction cannot now be revised, and amended returns in respect thereof cannot be accepted. The corporation is required to submit with its return a statement of the additions proposed, specifying the kinds and amounts of property involved, the years in which the expenditures were made, and the method followed in distinguishing between capital outlays and current expenses, and showing that adequate provision has been made for depreciation, obsolescence and depletion of such of the assets affected by the additions as are subject to recognized depreciation, obsolescence or depletion. In any case in which there is an operating deficit, amounts restored must first be set off against the deficit and only the excess can be actually included in the computation of invested capital.[1]

[1] Reg. 45, Art. 841.

Property Paid in and Subsequently Written Off. Where tangible or intangible property has been paid in to a corporation for stock or shares or as paid-in surplus, and has subsequently been in whole or in part written off the books, the amount so written off may upon evidence satisfactory to the Commissioner be restored to the capital or surplus account subject to the following limitations: (1) The amount restored must be reduced by a proper deduction for any depreciation, obsolescence or depletion; and (2) the aggregate amount included in computing invested capital on account of such property must not exceed the amount which might have been included if such property had not been written off.[1]

[1] Reg. 45, Art. 842.

Admissible Assets. The term "admissible assets" means all assets other than inadmissible assets. Organization expenses and deferred charges against future income are admissible assets. Admissible assets must be valued in accordance with the provisions of the law regarding invested capital.[1] Thus, for example, intangible property paid in for stock or shares is an admissible asset, but it cannot be valued at an amount in excess of that at which it may be included in computing invested capital under the provision of law limiting such amount to 25% of the par value of the total stock or shares of the corporation outstanding on March 3, 1917, or at the beginning of the taxable year accordingly as such property was paid in prior to or on or after March 3, 1917.[2]

[1] Revenue Act of 1918, § 325.

[2] Reg. 45, Art. 818. Revenue Act of 1918, § 326 (a) 4, 5. Good will so far as it is built up and developed by advertising not charged to expense may be included in invested capital. A corporation may in the future exercise an option and, if it so desires, treat advertising as a capital item, not deducting it as an expense, in which case it may become entitled to include a pro tanto amount of good will in its invested capital and make an addition to surplus accordingly.

Inadmissible Assets. The term "inadmissible assets" means stocks, bonds, and other obligations (other than obligations of the United States) the dividends or interest from which are not required to be included in computing net income. Where, however, the income derived from such assets consists in part of gain or profit derived from the sale or other disposition thereof, or where all or part of the interest derived from such assets is in effect included in the net income because of the limitation upon the deduction of interest,[1] the corresponding part of such assets is not deemed to be inadmissible.[2] A corporation cannot by including the income from inadmissible assets as taxable income create the right to have such assets considered admissible assets.[3] Inadmissible assets will for the

[1] See Revenue Act of 1918, § 234 (a) 2.

[2] Revenue Act of 1918, § 325.

[3] Reg. 45, Art. 815.

purpose of discussion in the following paragraphs be divided into three classes, (1) stocks of domestic corporations (2) stocks of foreign corporations and (3) bonds and other obligations.

STOCK IN FEDERAL RESERVE BANK. Federal Reserve Bank stock, held by a member bank, is an inadmissible asset in determining invested capital.[1]

[1] Letter from Treasury Department dated March 13, 1919; W. T. S. 1919, ¶ 1014; O. D. 81, Treasury Bulletin 1-19-118.

STOCK OF DOMESTIC CORPORATIONS. The statute apparently intends that stocks of domestic corporations are *ipso facto* inadmissible assets in computing the invested capital of the stockholder. The law provides that the term "inadmissible assets" means "stocks * * * the dividends * * * from which is [are] not included in computing net income."[1] Hence it follows that it is immaterial whether the corporation whose stock is held actually pays dividends thereon or not, or whether its operations are carried on within or without the jurisdiction of the United States. Although many corporations find it necessary for business reasons to hold stock in other corporations which do not pay dividends and such investment is in fact a necessary and proper investment, as for instance where several corporations may own the stock of storage, warehouse or terminal companies for their joint benefit (such jointly held corporations not being intended to pay dividends) the stock is nevertheless inadmissible under a literal interpretation of the law. To hold that stock of a domestic corporation is admissible if the corporation paid no dividends, during the taxable year, but inadmissible if the corporation paid dividends and the same were not included in the net income of the stockholder, would be to establish an impracticable rule, and one plainly not intended by the language of the law. Hence it has been ruled that the failure to pay or to receive dividends does not change the status of stock as an inadmissi-

[1] Revenue Act of 1918, § 325 (a).

ble asset.[2] Apparently the only way that stock of a domestic corporation can become an admissible asset is by selling the stock, in which case the profit is included in net income and all or a portion of the value of the stock becomes an admissible asset, as is more fully stated in a subsequent paragraph.

[2] Reg. 45, Art. 815.

STOCK OF FOREIGN CORPORATIONS. If a foreign corporation pays an income tax to the United States on any part of its income, its dividends are not taxed as income when received by a domestic corporation[1] and it follows that the stock of such foreign corporation is an inadmissible asset.[2] On the other hand, if such foreign corporation pays no income tax to the United States its stock is an admissible asset.[3]

[1] Letter from Treasury Department, dated June 9, 1919; I. T. S. 1919, ¶ 3427. See p. 297 of the 1920 edition.

[2] O. D. 305, Treasury Bulletin 24-19-576.

[3] The rule was different under the 1917 law. See Reg. 41, Art. 27. But it seems that the rule stated in the text is applicable to assessments under that law as well as the present law.

BONDS OR OTHER OBLIGATIONS. The bonds or other obligations which are inadmissible assets are only those "the interest from which is not included in computing net income."[1] Bonds and securities of industrial or railroad corporations—domestic or foreign—are admissible, even though the bond may have a so-called "tax-free covenant." Bonds issued by exempt corporations are admissible assets. Bonds and obligations of the United States are admissible although the interest may be exempt. Such bonds, however, are only bonds of the Federal Government and not of its possessions. Bonds and obligations which are inadmissible assets are those issued by a state or territory (or a political subdivision of either, i. e., county, city, township, etc.), the District of Columbia and the possessions of the United States, and also securities issued under the provisions of the Federal Farm Loan Act of July 17, 1916.[2] Bonds

[1] Revenue Act of 1918, § 325 (a).

[2] Reg. 45, Arts. 815-816.

of the War Finance Corporation are admissible if the income therefrom is subject to the tax, but that part of the principal amount of such bonds with respect to which interest may be exempt from excess-profits tax is inadmissible. Thus, bonds of the War Finance Corporation the principal of which does not exceed $5,000 are inadmissible assets, and bonds of the War Finance Corporation the principal of which exceeds $5,000 are admissible assets.[3] Since the income derived from Porto Rico bonds is not subject to tax, the bonds are inadmissible assets and can not therefore be included in invested capital.[4] The conversion of certificates of indebtedness purchased by a corporation in 1918 into Victory Liberty Loan notes of the same value does not affect invested capital.[5] In computing the amount of admissible assets, the total cost of bonds subscribed for, whether fully paid or not, may be included in admissible assets.[6]

[3] Official Announcement by the Bureau of Internal Revenue, dated April 5, 1919; O. D. 781, Treasury Bulletin 1-19-116.

[4] O. D. 86, Treasury Bulletin 1-19-125.

[5] O. D. 93, Treasury Bulletin 1-19-132.

[6] O. D. 28, Treasury Bulletin 1-19-40.

Inadmissible Assets May Become Admissible. Under two conditions assets which are otherwise inadmissible become in whole or in part admissible: (1) Where the inadmissible asset has been sold during the year and the profit thereon is included in net income, and (2) where inadmissible assets have been purchased or carried during the year with borrowed money and the interest paid on such borrowed money is not allowed to be deducted in ascertaining the net income.[1] Where inadmissible assets have been sold or otherwise disposed of, the total income from such assets including the profit on the sale and the interest or dividends received during the year is first ascertained. Secondly, the percentage of the entire net income attributable to the profit on the sale of the asset is ascertained and the same percentage of the intangible asset becomes invested capital for the length of time such

[1] See Revenue Act of 1918, § 234 (a) 2, also p. 358 of the 1920 edition.

asset was owned by the corporation.[2] In the second class of cases it seems that the interest received from the inadmissible asset should be compared with the interest paid upon the money borrowed to purchase or carry such asset. Thus, if the interest received is $100 and the interest paid on the borrowed money is $75, three-fourths of the inadmissible asset becomes admissible (since three-fourths of the interest is in effect included in taxable income). This applies separately to each issue or class of inadmissible securities held by a corporation. For example, it may hold A company stock costing $100,000 and B company stock costing $200,000. During the year it receives $8,000 in dividends from A company and $5,000 from B company, and on September 30 sells part of its B company stock at a profit of $3,000. For the period from January 1 to September 30, $75,000 of its holdings of B company stock become admissible. After September 30 its remaining holdings of B company stock are inadmissible, but the proceeds of the sale are admissible unless invested in admissibles.[3]

[2] Under the 1917 Law it was held that wherever income consisted partly of gains or profits subject to the excess-profits tax arising from trading in stocks, bonds, etc., the dividends or interest on which were not subject to such tax, and partly from such dividends or interest, there could be included in the invested capital an amount which bore the same ratio to the total amount invested in such stock or bonds as the amount of such trading profits bore to the total amount of trading profits and dividends or interest. (Reg. 41, Art. 45.)

[3] Reg. 45, Art. 817.

Reduction of Invested Capital by Inadmissible Assets. From invested capital must be deducted a percentage thereof equal to the percentage which the amount of inadmissible assets is of the amount of admissible and inadmissible assets held during the year.[1] In other words, after the invested capital has been determined without reference to inadmissible assets but eliminating borrowed capital, the invested capital so determined is reduced by taking a percentage equal to the percentage of inadmissible assets to all the assets held during the

[1] Revenue Act of 1918, § 326 (b).

taxable year.[2] For the purpose of ascertaining the deductible percentage the amount of inadmissible assets held during the year may ordinarily be determined by dividing by two the sum of the amount of such assets held at the beginning of the year and the amount held at the end of the year. The total amount of admissible and inadmissible assets held during the year may ordinarily be determined by dividing by two the sum of the amount of such assets held at the beginning of the year and the amount at the end of the year. If at any time a substantial change has taken place either in the amount of inadmissible assets or in the total amount of admissible and inadmissible assets, the effect of such change should be averaged exactly from the date on which it occurred. In any case where the Commissioner finds that either amount determined as above provided does not substantially reflect the average situation throughout the year, and that the amount of each kind of assets held on a given day of each month throughout the year or at more frequent regular intervals can be determined, the amount of inadmissible assets and the amount of both kinds of assets held during the year will be determined by averaging the amounts held at such several times. In making these computations the valuation at which each asset is carried must be adjusted in accordance with the provisions of the statute and of the regulations relating to the valuation of assets for the purpose of computing invested capital including in such adjustment the amount of reserves for depreciation, depletion, amortization and other reserves which represent the valuation of assets. It is immaterial whether any asset was acquired out of invested capital, or out of profits earned during the year, or borrowed capital.[3]

[2] Under the 1917 Law it was ruled that only so much of the admissible assets as exceeded the borrowed money need be deducted from invested capital. See letter from Treasury Department dated April 2, 1918; W. T. S. 1918, ¶ 923 and letter dated May 17, 1918, Id. ¶ 955.

[3] Reg. 45, Art. 852. As to affiliated corporations see p. 708 of the 1920 edition. Under the 1917 Law, if admissible assets were in excess of adjusted capital and surplus, no further deduction was required because of inadmissible assets; in other words, only the excess of in-

admissible assets over total indebtedness was required to be deducted from adjusted capital and surplus (A. R. R. 111, Treasury Bulletin 21-20-964.) This ruling is inapplicable under the present statute which provides for the deduction of a *percentage* of inadmissibles.

Borrowed Capital. The term "borrowed capital" means money and other property borrowed whether represented by bonds, notes, open accounts, or otherwise.[1] Invested capital does not include borrowed capital.[2] Where the amount of borrowed capital is abnormal, however, the taxpayer may apply for assessment by reference to representative corporations.[3] Any interest in a corporation represented by bonds, debentures or other securities, by whatever name called, including so-called preferred stock, if with respect to the payment of either interest or principal it ranks with or prior to the interest of the general creditors, is borrowed capital and cannot be included in computing invested capital. Any such preferred stock may, however, be so included if it is deferred with respect to the payment of both interest and principal to the interest of the general creditors.[4] Preferred stock if in the records of the corporation it is declared to be part of its capital stock, though convertible into first-mortgage bonds of even date therewith, is inferior, on a distribution of assets to pay debts, to the rights of general creditors, and is to be treated as invested capital so

[1] Revenue Act of 1918, § 325 (a). Under the 1917 Law it was held that the term "money or other property borrowed" included not only cash or other borrowed property which could be identified as such, but current liabilities and temporary indebtedness of all kinds, and any permanent indebtedness upon which the taxpayer was entitled to an interest deduction in computing net income. (Reg. 41, Art. 44.)

[2] Revenue Act of 1918, § 326 (b).

[3] See p. 699 of the 1920 edition.

[4] Reg. 45, Art. 812. Where the principal stockholder of a corporation loans money to the corporation and, in order to protect the credit of the corporation an agreement is signed to the effect that the lender shall be deferred to all other creditors and shall receive one per cent. additional interest in consideration thereof, which interest is not deducted by the corporation as expense, the amount of the loan cannot be included in invested capital as preferred stock. (Telegram from Treasury Department dated April 4, 1919; W. T. S. 1919, ¶ 1021.)

long as it is not converted.[5] The question is not what the parties call an instrument but what the facts and circumstances require it to be called. The courts are not influenced by mere names but look beyond names and give to the subject dealt with the character and status which its properties denote it possesses.[6] The term "debenture" is well-known in England to describe any instrument issued by a corporation which creates or acknowledges a debt. As stated by Lindley, debenture stock is of the same nature as ordinary debentures, except that instead of each bond securing a definite amount, the whole sum secured is treated as a single stock, the bonds are issued declaring the holder to be entitled to a definite sum, part of this stock. This sum is not necessarily a round sum, but may be for any number of pounds, it may include fractions of a pound unless limitation is made in that respect. A debenture stock may be repayable at a fixed date, or may be irredeemable, according to the deed creating it, and may be secured in any manner in which a debenture may be secured.[7] Irredeemable notes or bonds are not so well known in this country. There are instances, however, of such perpetual debts and it has been held that the character of such obligations is not affected by the fact that they are not redeemable at a fixed time.[8] Certificates stating that a corporation is indebted in a specified amount to the holders thereof payable at the expiration of corporate existence, the payment of the principal being subordinated to other indebtedness, may still be regarded as a debt and consequently as borrowed capital. Such certificates do not constitute preferred stock. The term "stock" does not mean a debt but refers to an interest in a corporate enterprise.[9]

[5] S. 1200, Treasury Bulletin 27-19-609.

[6] Spencer v. Smith, 201 Fed. 647; Heller v. National Marine Bank, 89 Md. 601, 43 Atl. 800.

[7] Lindley's Company Law, 195.

[8] Philadelphia & Reading R. Co. v. Stichter, 11 Weekly Notes of Cases, Pennsylvania, 325.

[9] It should be noted that the instruments under consideration in this ruling afforded some security to the holders thereof by a provision preventing the corporation from mortgaging its property or franchises without the written consent of at least two-thirds of the holders. There were no indications that the parties intended the holders to be stock-

holders, the certificates having been issued under a clause in the charter granting power to borrow money and not to issue stock. The certificates provided specifically for the payment of interest at a specified rate per annum. There was no qualification in the charter or by-laws of the company limiting this obligation and no reason appeared why the holders of such certificates could not sue for the interest if default in payment was made. These considerations were foreign to the idea of preferred stock since a preferred stockholder is not a creditor of the corporation (Warren v. King, 108 U. S. 389, 2 Sup. Ct. 789) and cannot sue for dividends unless they are declared. Moreover, there was no indication in the charter or by-laws of an intent that the holders of the certificates should share in the corporate assets over and above the first amount of their interest.

Whether or not amounts received by a corporation upon the sale of so-called debenture stock constitute invested capital or borrowed capital depends upon the rights and powers enjoyed by the holders of such stock and the obligations with respect thereto undertaken by the corporation; where so-called debenture stock is issued by a corporation for cash or property under a power granted by the charter to borrow money, and the certificates of such stock contain an agreement on the part of the corporation to repay the face amount thereof upon dissolution, and to pay interest thereon from time to time, at a certain rate per cent. per annum; and where it appears that the claim of such debenture stockholders will, upon dissolution of the corporation, be subordinate to the claims of general creditors but superior to the claims of the ordinary stockholders; and where it further appears that the holders of such certificates exercise no voice in the control or management of the corporation, the amounts received for the sale of such stock constitute borrowed capital, and the interest paid thereon, from time to time, by the corporation is properly deductible as a business expense.[10]

Whether a given amount paid into or left in the business of a corporation constitutes borrowed capital or paid-in surplus is largely a question of fact. Thus, indebtedness to stockholders actually canceled and left in the business would ordinarily constitute paid-in surplus, while amounts left in the business representing salaries of officers in excess of their

[10] A. R. R. 237, Treasury Bulletin 33-20-1142.

actual withdrawals or deposit accounts in favor of partners in a partnership succeeded by the corporation, will be considered paid-in surplus or borrowed capital according to the facts of the particular case. The general principle is that if interest is paid or is to be paid on any such amount, or if the stockholder's or officer's right to repayment of such amount ranks with or before that of the general creditors, the amount so left with the corporation must be considered as borrowed capital.[11] In 1915 the principal stockholders paid into a company a sum of money, no stock being issued therefor, no interest charged, and no action was taken by the corporation to indicate the nature of the payment except that it was entered as a contribution to capital and was never treated as an account payable. The sum was repaid in 1917, there being no evidence as to the nature of the payment nor how it was treated by the corporation. It was held that the payment was in the nature of a voluntary assessment; that the repayment must be deemed to be out of undivided profits or earned surplus so far as possible; that such repayment could not be treated as a return of capital unless the undivided profits and earned surplus accumulated since March 1, 1913, were first distributed as dividends; that the corporation should be permitted to include the amount in its invested capital for 1917 as paid-in surplus, proper adjustment being made for any distributions of dividends in excess of available net earnings.[12] In a case arising under the 1917 Law, an amount was paid in to a corporation regularly by its stockholders under a resolution making an assessment upon such stockholders. This amount was entered on the corporation's books as a capital reserve fund and in 1917 was carried as "advances by stockholders". No stock was issued for the amount and no notes were given by the corporation acknowledging its indebtedness to the stockholders therefor. Interest was paid upon the advance and was deducted by the corporation regularly each year in computing net income. The Treasury Department held this advance by the stockholders not to constitute borrowed capital and per-

[11] Reg. 45, Art. 813.
[12] T. B. M. 82, Treasury Bulletin 23-19-552.

mitted its inclusion in invested capital on the theory that the stockholders would not be entitled to repayment before the general creditors had been satisfied. The interest paid by the corporation was regarded as in the nature of a dividend upon preferred stock.[13] Items such as deposits or amounts due to other banks shown in the balance sheet of a bank, unexpired subscriptions shown in the balance sheet of a publishing concern, etc., are deemed liabilities and can not be included in computing invested capital.[14] Where upon the organization of a corporation bonds were issued for the tangible property received and interest was paid to the owners of such bonds up to the year 1917 (paid and deducted by the corporation to the year 1917) it has been held under the Revenue Act of 1917 that the amount of such bonds is borrowed capital and can not be included in invested capital even though the minutes of the organization meeting of the corporation contained a resolution providing that the bonds should be "subject to all rights of creditors of said corporation now existing and at all times existing during the terms of said bonds" and even though in 1918 the bondholders turned in their bonds in exchange for preferred stock. It was held that the fact that the corporation did not deduct interest on the bonds in filing its 1917 returns was not sufficient to change or fix the status for purposes of invested capital nor was the subordination of the liens of the bonds to the claims of general creditors.[15]

[13] A. R. M. 44, Treasury Bulletin 18-20-905. See also A. R. R. 78, Treasury Bulletin 18-20-904.

[14] Reg. 45, Art. 814.

[15] A. R. R. 116, Treasury Bulletin 21-20-962.

CONVERSION OF BONDS INTO STOCK. Where bonds are exchanged for stock in the same corporation under the terms of a convertible trust deed, it will be presumed, for the purpose of computing invested capital, that the value of the bonds is equivalent to the value of the stock. The addition to invested capital would accordingly be the amount for which the bonds were originally sold.[1]

[1] O. D. 306, Treasury Bulletin 24-19-577.

Computing Invested Capital. In computing invested capital the first step is to add together the paid-in capital and paid-in or earned surplus and undivided profits (under whatever name the same may be called) as shown by the books at the beginning of the taxable year. The total thus obtained is to be adjusted for any asset or item which it covers that is not carried on the books at the valuation prescribed by law.[1] After the various adjustments are made the adjusted total of the capital and surplus account will represent the invested capital at the beginning of the taxable year. If there has been any change made during the taxable year in the amount of invested capital, the reduction or increase must be noted in order to average the invested capital for the year. Whenever any corrections are made in respect of the capital stock or surplus, corresponding corrections must be made in the respective asset items in the balance sheet of the taxpayer accompanying the return.[2] But it is not necessary that the books also be changed provided some permanent record of the adjustments is kept.[3]

[1] This was the rule under the 1917 Law. See Reg. 41, Art. 53.
[2] Reg. 41, Art. 53.
[3] Letter from Treasury Department dated March 19, 1918.

Adjustments Which Increase Book Values of Assets. The adjustments which may increase the book value of the assets representing capital and surplus at the beginning of the year (and thus increase the surplus for purposes of invested capital) are stated in the preceding paragraphs.[1] Briefly summarized they are (a) the value of tangible property paid in in excess of the par value of the stock issued therefor; (b) additions to the capital account due to restoring to the capital account the value of assets the cost of which has been charged to expense; (c) reinstating the value of assets which has been unduly reduced on the books of the company, and (d) the inclusion of reserves or such parts of reserves as are in fact surplus or undivided profits. In support of the claim for additional invested capital with respect to any of these items it is necessary to file statements showing the information indicated in the respective paragraphs above.

[1] See p. 671 of the 1920 edition.

Adjustments Which Reduce the Book Value of Assets. Assets may be carried on the books at a valuation greater than that which the law expressly allows or contemplates. In such cases the value of such assets must be reduced to within the limit allowed by law and the capital, surplus or undivided profits of a company reduced accordingly. Cases in which adjustment must be made to reduce the book value are stated in the following paragraphs.

AS TO VALUE OF INTANGIBLE ASSETS. As stated above in the paragraphs relating to intangible property paid in[1] the value thereof must be reduced to the lowest of three values: (a) the actual cash value at the time of acquisition; (b) the par value of the stock issued therefor, or (c) 25% of the par value of the stock outstanding on March 3, 1917, or at the beginning of the taxable year as the case may be. The difference between such minimum value and the value at which the assets are carried on the books of the company is the amount to be deducted in this adjustment.

[1] See p. 661 of the 1920 edition.

AS TO TREASURY STOCK. When any treasury stock is returned to the corporation as a gift or for a consideration substantially less than its par value, the stock so returned may not be treated as a part of the stock issued or exchanged for property. The proceeds derived in cash or its equivalent from the resale of such treasury stock should however be included in the invested capital, if retained and employed in the business.[1] The difference between the par value of the treasury stock so returned as a gift and the amount of cash or its equivalent which was derived from the resale of such stock is required to be deducted from invested capital.[2] Where a cor-

[1] Reg. 41, Art. 54; Reg. 45, Art. 861.

[2] See Form 1120 for 1918, Schedule G3. There may be cases, however, where the subsequent return of stock to the corporation is in fact equivalent to an additional contribution of capital equal to the amount received by the corporation on the resale of such stock. Where stock has been issued for property and a part of the stock is returned to the treasury of the corporation, the presumption is that the property was consciously overvalued, but this presumption cannot stand if contrary to fact.

poration either directly or indirectly, as for example through a trustee, has prior to the taxable year bought its own stock, either for the purpose of retirement or of holding it in the treasury or for other purposes, the entire cost of such stock must be deducted from the aggregate invested capital as of the beginning of the taxable year, if such deduction has not already been made. Where such stock is purchased during the taxable year a deduction from the invested capital as of the beginning of the taxable year and effective from the date of such purchase is required only to the extent that such stock has not been purchased out of the undivided profits of the taxable year. The full amount derived in cash or its equivalent from the resale of such stock may be included in invested capital from the date of such resale, unless such stock had been purchased out of earnings of the taxable year.[3]

[3] Reg. 45, Art. 862.

As to Value of Assets Acquired in Reorganization. In the case of a reorganization, consolidation or change of ownership of a trade or business, or change of ownership of property, after March 3, 1917, certain reductions may be necessary in the book values of the new owner, if such book values reflect the value of the property at the time it was acquired by such new owner. Such reduction is necessary only in cases where 50% or more of the interest or control in such trade or business or property remains[1] in the same persons, or any of them. In such cases no asset so acquired will, for the purpose of determining invested capital, be allowed a greater value than would have been allowed in computing the invested capital of the previous owner if such asset had not been so transferred to the new owner. In other words, if the previous owner was a corporation and 50% or more of the interest or control of the new corporation remains in the hands of any of those who controlled the old corporation, the intent of the statute seems to be that the invested capital of the new corpora-

[1] It seems that under the provision in its present form (Revenue Act of 1918, § 331) when the ownership of the trade or business or property ceases to "remain" to the extent of 50% in the same persons, the restriction no longer applies.

tion cannot be increased as to such property beyond the amount which would have been allowed to the old corporation had it retained the assets. This is true whether or not the assets were paid for by the new corporation in stock or in cash.[2] If the previous owner was not a corporation, then the value of any asset so transferred must be taken at its cost of acquisition (at the date when acquired by such previous owner) with proper allowance for depreciation, impairment, betterment or development, but no addition to the original cost may be made for any charge or expenditure deducted as expense, or otherwise, on or after March 1, 1913, in computing the net income of such previous owner for purposes of taxation.[3] In all such cases the reduction to be made is the difference between (a) the book value of such assets, and (b) in case the previous owner was a corporation, the value at which the asset would have been considered invested capital to it, or (c) in case the previous owner was an individual the cost of such asset to such owner, as indicated above.

A new corporation which raises a certain sum from the sale of its capital stock as a condition precedent to taking over from the creditors of a defunct corporation the old corporation's assets and assuming its liabilities will not be allowed as invested capital the amount which the old corporation could have claimed. It is limited to the amount received from the sale of its capital stock. The value of the property received on condition of the assumption of the unpaid liabilities of the old corporation is borrowed capital.[4]

In the above case the old corporation had gone into the hands of a receiver and its property sold to its creditors who were not stockholders. The transaction was closed and completed so far as the old corporation and its stockholders were

[2] Under the 1917 Law this restriction on the value of assets acquired on a reorganization after March 3, 1917, applied only to cases where the asset was not paid for specifically as such in cash or tangible property, (Revenue Act of 1917, § 208; Reg. 41, Art. 501) but under the present law it applies also to cases where payment may have been made in cash or by tangible property. (Revenue Act of 1918, § 331.)

[3] Revenue Act of 1918, § 331.

[4] T. B. M. 49, Treasury Bulletin 11-19-389.

concerned. The fact that the stockholders of the old and new corporations were identical does not affect the question.

It will be noted that the Revenue Act of 1918 in its provision regarding reorganizations extends the corresponding provision of the Revenue Act of 1917 to include a "change of ownership of property after March 3, 1917."[5]

[5] A. R. R. 285, Treasury Bulletin 42-20-1252.

REORGANIZATIONS ENTITLING CORPORATIONS TO REVALUATION. The provision referred to in the preceding paragraph provides negatively that in the case of a reorganization, consolidation or change of ownership of a trade or business or change of ownership of property after March 3, 1917, if an interest or control in such trade of business or property of 50% or more remains in the same persons, or any of them, then no asset transferred or received shall be allowed a greater value in determining invested capital than would have been allowed to the previous owner. Two inferences are to be fairly drawn from this provision: (1) assets in the case of reorganization *prior to* March 3, 1917, should be valued as of the date of transfer to the new corporation for the purpose of determining the invested capital of such corporation for the taxable year;[1] (2) assets in the case of a reorganization after March 3, 1917, should be valued as of the date of the transfer to the new corporation for the purpose of determining the invested capital of such corporation for the taxable year, *if an interest or control in the trade, business or property transferred upon the reorganization does not remain to the extent of 50% or more in the same persons.* In cases arising upon this side of the question a revaluation of assets has been permitted for purposes of determining invested capital. It has been expressly ruled that in a case falling under (1) above a revaluation of assets is to be permitted for purposes of invested capital where there was a change of corporate entity prior to March 3, 1917, even though there was no change of officers, or directors, or proportions of stockholders. Inasmuch as the Treasury Depart-

[1] A. R. R. 268, Treasury Bulletin 41-20-1238; A. R. M. 60, Treasury Bulletin 25-20-1022.

ment treats the stockholders of a reorganized corporation, who surrender their stock, as liable to income tax if the value of the stock received is in excess of the cost of the stock surrendered, or its value on March 1, 1913, it feels bound to permit the new corporation to obtain the benefit of a revaluation of corporation assets for purposes of invested capital.[2]

Where two corporations are engaged in different branches of the same business and the certificate of incorporation of one is amended so as to change its name and increase its capital stock, which new stock is issued prior to March 3, 1917, in exchange for the stock of the two original companies, the invested capital of the corporation whose certificate has been so amended will be determined by adding to such corporation's original invested capital prior to the transaction the appreciated value (as of the date of the exchange of stock) of the assets of the other corporation the control of which had been transferred. No appreciation of value for purposes of invested capital is allowable with respect to the corporation which amended its certificate since there was no change of identity on the part of this corporation.[3] Where a corporation transfers its property to an association composed of its stockholders and the association after January 1, 1914, but prior to March 3, 1917, transfers substantially the same assets to a new corporation, the fair market value of such assets when transferred to the new corporation should be included in determining the invested capital of the latter.[4] The revaluation of assets upon a reorganization may not always result in an appreciated value. The invested capital of a corporation is measured by the original capital contribution of the stockholders and need not be reduced by any subsequent deficit in the nature of an operating loss. Likewise, depreciation and depletion of capital assets need only be applied

[2] A. R. M. 60, Treasury Bulletin 25-20-1022.

[3] O. 872, Treasury Bulletin 10-19-365; see A. R. R. 285, Treasury Bulletin 42-20-1252; Sol. Op. 41, Treasury Bulletin 34-20-1159. This decision is silent as to whether the corporation whose assets were appreciated for purposes of invested capital was subjected to income tax to the extent of such appreciation.

[4] Sol. Op. 41, Treasury Bulletin 34-20-1159.

against *earned* surplus and need not be applied against capital on *paid-in surplus*.[5] In the case of a corporation the capital of which has been impaired by losses or by depletion or depreciation not properly allowed for, a reorganization may result in a capital contribution to the new corporation smaller than the original capital contribution of the stockholders of the old corporation. In the case of such a reorganization prior to March 3, 1917, or after that date, provided the interest or control of the assets is changed, the reorganized corporation may by virtue of the reorganization be obliged in effect to reduce what would have been the invested capital of the old corporation by the amount of any such loss, depletion or depreciation. The mere change of domicile of a corporation without change as to capital and surplus does not affect invested capital even though the new corporation is an entity distinct from the old. In such case the charter issued in one state has merely been surrendered in exchange for a new charter in another state without change in the business or amount of capital and surplus and the new corporation is entitled to the same invested capital as the old.[6]

[5] Reg. 45, Art. 860; letter from Treasury Department dated March 19, 1918; letter from Treasury Department dated April 14, 1916; W. T. S. 1919, paragraph 1042.

[6] A. R. R. 16, Treasury Bulletin 3-20-697.

As to Values Marked up on the Books of Account. Invested capital cannot be based upon an appraisement showing the value as of any date subsequent to the date of acquisition.[1] Therefore, if a corporation has marked up the value of any of its assets the amount by which the original book values have been so increased must be deducted.

[1] Reg. 45, Art. 831; Letter from Treasury Department dated March 5, 1918.

As to Inadequate Allowance for Depreciation or Depletion. Where the corporation has not duly marked down the value of its property subject to depreciation, or set up a depreciation reserve to provide for replacement of values lost by depreciation, from the time the property was acquired

down to the beginning of the taxable year, the proper amount of depreciation suffered during that period must be computed and deducted from the value of the assets in order to reach their present value at the beginning of the taxable year.[1] Such depreciation cannot be offset by any unrealized appreciation.[2] Since the law contemplates that the invested capital shall be measured by the value of the original contribution of the stockholders to the corporation, paid-in surplus representing tangible property need not be reduced by reason of depreciation. All adjustments necessary on account of inadequate or excessive depreciation should be made in connection with *earned* surplus or undivided profits. Therefore, if a corporation is properly entitled to add to its invested capital in the form of paid-in surplus an amount representing excess in value of property, over the consideration paid therefor, such paid-in surplus need not be reduced on account of depreciation of the property on which the excess value is claimed. It should be borne in mind, however, that while paid-in surplus as indicated above, need not be reduced on account of depreciation, such adjustment must be made in *earned* surplus or undivided profits, and the computation must be based not on the cash paid or stock issued for the property but on its actual value at the time acquired for the purpose of computing the allowable addition to paid-in surplus.[3] Similar reduction must also be made in case of inadequate allowance for depletion.[4]

[1] See Reg. 41, Art. 42.

[2] A. R. R. 71, Treasury Bulletin 18-20-906.

[3] Letter from Treasury Department dated April 14, 1919; W. T. S. 1919, ¶ 1042; O. D. 90, Treasury Bulletin 1-19-129.

[4] See p. 666 of 1920 edition.

AS TO LOSSES. Where a loss has taken place, and the value of the asset has not been marked down accordingly, the amount of such loss must be deducted in this adjustment. But where a loss has taken place it will be taken into account only to the extent that it has wiped out earned surplus. The amount of the original capital contributed by the stockholders is not reduced by reason of the loss, but no new surplus can be included as invested capital until the full loss chargeable against

the capital account has been made good.[1] Good will created to offset impaired capital has no effect on invested capital. Subsequent earnings must be used first to restore impaired capital, excess may be added to original investment as invested capital.[2] A corporation to which a certain amount of capital was once contributed, and which has not paid back any part thereof to its stockholders, either directly or indirectly, is allowed to claim the entire amount originally contributed as invested capital, regardless of losses which may have impaired such capital, provided the corporation has no surpus against which the loss can be charged. In other words, a corporation which has a deficit instead of a surplus may disregard the deficit in the computation of its invested capital. Losses which must be taken into consideration under this adjustment are those which have been actually sustained. The mere depreciation in market value of assets is not considered to be a loss impairing invested capital. Thus, stock of other corporations may have been purchased at par and at the beginning of the taxable year may have a market value of only 75. Nevertheless, until the stock is sold, it may for purposes of invested capital be carried at its original cost, and if the corporation has marked the value down to market, it may restore the value to original cost. On the other hand, such marking down of assets to market (except in the case of dealers who inventory their stock) does not create a loss which may be deducted in computing the net income. In the case of dealers who inventory their stock, the inventory value would govern and the cost value cannot be restored.

[1] Letter from Treasury Department dated March 19, 1918; Reg. 45, Art. 860.

[2] O. D. 82, Treasury Bulletin 1-19-121.

ALLOWANCE FOR AMORTIZATION UNDER MUNITION MANUFACTURER'S TAX. The Munition Manufacturer's tax was laid upon the entire *net profits* actually received or accrued, from the sale or disposition of specific munitions, and it was provided in Section 302 "That in computing net profits under the provisions of this title, for the purpose of the tax there shall be allowed as deductions from the gross amount received

or accrued for the taxable year from the sale or disposition of such articles manufactured within the United States, the following items: * * * (f) A reasonable allowance according to the conditions peculiar to each concern, for amortization of the values of buildings and machinery, account being taken of the exceptional depreciation of special plants." It is apparent from this language that the amortization allowance in question was authorized for the purpose of computing "net profits," not "net income." The right to make a deduction for amortization in computing net income for the income tax did not exist and was repeatedly denied by the Treasury Department prior to the passage of the Revenue Act of 1918. It is to be noted further that the taxes imposed by Title II of the Revenue Act of 1917 and Title III of the Revenue Act of 1918 were explicitly laid upon "net income," and were in a variety of ways impressed with the stamp and character of an income rather than a munition manufacturer's tax. They are in no sense mere continuations or expansions of the tax imposed by Title III of the Revenue Act of 1916. It follows, therefore, that the deduction for amortization under the Munition Manufacturer's Tax law was not allowed for income tax purposes and should not now be permitted to affect the surplus or any other element entering into the "invested capital" employed for purposes of the war-profits and excess-profits taxes. In ruling upon a particular case the Treasury Department stated: "This conclusion is supported by the character of the amortization allowance in question. It was in many respects quite dissimilar from the depreciation and depletion allowances. It was not based upon the fact that plant and equipment acquired in the year 1916 or earlier for the manufacture of munitions, actually depreciated in use or market value during the taxable year 1916. There was in general no such depreciation in value or impairment of useful life. Account was taken 'of the exceptional depreciation of special plants' but the principal allowance was 'for the amortization *of the values* of buildings and machinery,' whether those values increased or decreased in the immediate future. The principal amortization allowance looked to the establishment of a special fund

to recoup exceptional war costs when war uses had ceased; it did not imply that there had been or would be any immediate impairment of physical assets, such as is covered by the depletion allowance, or any immediate exhaustion, wear, tear or obsolescence in excess of the amount covered by the depreciation allowance. It was, as stated, a special allowance peculiar to this tax, designed possibly to moderate the (then) exceptionally high rates of the Munition Manufacturer's Tax."[1]

[1] Letter from Treasury Department dated August 13, 1919; W. T .S. 1919, ¶ 1051; T. B. M. 56, Treasury Bulletin 15-19-452.

AS TO INADMISSIBLE ASSETS. The adjustment by way of reduction of invested capital which must be made with respect to inadmissible assets is indicated in an earlier paragraph on that subject.[1] In the case of a corporation which has no borrowed money the reduction will equal the value of the inadmissible assets. In case the corporation has borrowed money the amount to be deducted is arrived at by deducting such proportion of the invested capital (excluding borrowed capital) as the proportion of inadmissible assets is to the total of inadmissible and admissible assets.[2] Under the 1917 Law adjustments for inadmissible assets were made on the theory that the borrowed money was used to purchase or carry the inadmissible assets and only the excess of such assets over the borrowed money was deducted from invested capital. Under the present law, the adjustment seems to be on the theory that capital, surplus and borrowed money are represented by the inadmissible assets in proportion to the amount that each bears to the aggregate capital, surplus and borrowed money.

[1] See p. 677 of the 1920 edition.
[2] Revenue Act of 1918, § 326 (c).

Adjustments Due to Changes in the Taxable Year. After the invested capital has been ascertained as at the beginning of the year certain adjustments may be necessary to ascertain the average invested capital during the year, which is the amount contemplated by the law.[1] The invested capital as of

[1] Revenue Act of 1918, § 326 (d).

the beginning of any period of one year or less should be adjusted by an appropriate addition or deduction for each change in invested capital during the period. The amount so added or deducted in each case is the amount of the change averaged for the time remaining in the period during which it is in effect.[2] The fraction used in finding such average is the number of days remaining in the period (including the day on which the change occurs) over the number of days in the period. Thus, if a return is made for the calendar year ending December 31, 1918, and if $100,000 of additional capital was paid in on February 17, 1918, this addition to the invested capital is in effect for 318 days, and the amount to be added to the invested capital as of the beginning of the year would be 318/365 of $100,000 or $87,123.29. If $50,000 of this amount was withdrawn on October 31, 1918, the amount to be deducted would be 62/365 of $50,000, or $8,493.15.[3]

[2] The 1917 Law provided that the invested capital should be "averaged monthly" but the Treasury Department instead of adopting a monthly average required the invested capital to be averaged from the day on which the change took place. (See Form 1103 for 1917, Schedule D.) Under that law the following rules were made for ascertaining the average invested capital: (a) Add the capital for each of the several months during which no change occurs, and the average capital (ascertained as provided in subdivision (b) above) for each month in which a change occurs and divide the total by the number of months in the year or period. (b) To ascertain the capital for any month in which a change occurs multiply the capital as of the first day of the month by the number of days it remains constant and the capital after each change by the number of days (including the day on which the change occurs) during which it remains constant, add the products and divide the sum by the number of days in the month. (Reg. 41, Art. 43.)

[3] Reg. 45, Art. 853.

DIVIDENDS PAID FROM SURPLUS. The law expressly provides that any distribution of dividends made during the first sixty days of the year shall be deemed to have been made from the earnings or profits accumulated during the preceding taxable years.[1] A dividend other than a stock dividend affects the computation of invested capital from the date when the dividend is payable and not from the date when it is declared,

[1] Revenue Act of 1918, § 201 (e).

except that where no date is set for its payment the date when declared will be considered also the date when payable. For the purpose of computing invested capital a dividend paid after the expiration of the first sixty days of the taxable year will be deemed to be paid out of the net income of the taxable year to the extent of the net income available for such purpose on the date when it is payable. The method of determining available net income is stated in the next paragraph. The surplus and undivided profits as of the beginning of the taxable year will be reduced as of the date when the dividend is payable by the entire amount of any dividend paid during the first sixty days of the taxable year and by the amount of any other dividend in excess of the current net income available for its payment. In the case of a dividend paid during the first sixty days of a taxable year which exceeds in amount the surplus and undivided profits as of the beginning of the taxable year the excess will be deemed to be paid out of earnings of the taxable year available at the date when the dividend is payable, and to the extent that such earnings are insufficient it will be deemed to be a liquidation of paid in capital or surplus. From the date when a dividend is payable the amount which the several stockholders are entitled to receive will be treated as if actually paid to them, whether or not it is so paid in fact, and the surplus and undivided profits, either of the taxable year or of the preceding years, will in accordance with the foregoing provisions be deemed to be reduced as of that date by the full amount of the dividend. Amounts paid to stockholders in anticipation of dividends, or amounts withdrawn by stockholders in excess of dividends declared, will in computing invested capital have the same effect as if actually paid as dividends.[2]

[2] Reg. 45, Art. 858.

METHOD OF DETERMINING AVAILABLE NET INCOME. Whether at the time of any payment made during the taxable year there is sufficient income of the taxable year available for such payment, or whether the surplus or undivided profits as of the beginning of the taxable year must be reduced by the

amount of such payment, will be determined according to the following principles:

(1) The aggregate amount of earnings of the taxable year available for all purposes up to any given date will be determined upon the basis of the same proportion of the net income for the taxable year (as finally determined for the purpose of income and excess profits taxes) as the part of the year already elapsed is of the entire year, unless the corporation shows from its books or other records that a greater proportion of its earnings for the year was available on such date. A fairly accurate informal approximation of monthly earnings, made for the use of the officers of a corporation which did not close its books each month is insufficient to overthrow the general presumption in favor of the average or prorating method of ascertaining whether at the time of any payment made during the taxable year there is sufficient income of the taxable year available for such payment.[1]

(2) The aggregate amount available will be deemed to be applied for the following purposes in the order in which they are stated: (a) accrued Federal income and war-profits and excess-profits taxes for the taxable year, and (b) dividends paid after the expiration of the first sixty days of the taxable year and other corporate purposes, including the purchase of outstanding stock of the corporation previously issued.[2] In some cases the above computation would be indeterminate; for instance, in any case in which the amount distributed as a dividend exceeds the earnings of the taxable year to the date of the dividend payment plus the accrued Federal income and profits taxes on such earnings. In such cases the amount of invested capital for the purpose of this computation may be deemed to be the invested capital as of the beginning of the taxable year, plus any additional capital paid in during such year and minus any specific withdrawal or liquidation of capital during such year.[3]

The entire amount of Federal income, war-profits, and ex-

[1] T. B. R. 54, Treasury Bulletin 18-19-491.

[2] Reg. 45, Art. 857.

[3] Reg. 45, Art. 857; O. D. 619, Treasury Bulletin 31-20-1110.

cess-profits taxes accrued for the taxable year remains a part of invested capital for the succeeding year (since it is not deductible from gross income in returns) until the taxes become due in the succeeding year. Accrual of taxes for the taxable year does not affect invested capital for the taxable year, except to the extent that the accrual of such taxes will cause dividend payments to draw on surplus as at the beginning of the year.[4]

[4] O. D. 85, Treasury Bulletin 1-19-124.

EFFECT OF STOCK DIVIDEND. The payment of a stock dividend has no effect upon the amount of invested capital.

The distribution of a stock dividend is in effect a capitalization of current earnings or of earned surplus on hand at the beginning of the year. The capitalization of current earnings does not increase the invested capital, and the capitalization of surplus on hand at the beginning of the year does not decrease the invested capital.[1]

Such items as appraised value of good will, appreciation in value of real estate or other tangible property, etc., although carried to surplus and distributed as stock dividends, can not in this manner be capitalized and included in computing invested capital. If a corporation has paid a stock dividend in excess of its true surplus, it cannot be deemed to have any greater invested capital than could have been computed had no such stock dividend been paid.[2]

[1] T. B. R. 3, Treasury Bulletin 1-19-7.

[2] Reg. 45, Art. 859; T. B. R. 3, Treasury Bulletin 1-19-7. It has been held in the case of a corporation whose ore lands appreciated in value, the appreciation being first written up on the corporation's books as surplus and afterwards treated as the basis of a stock dividend, that such increase in value did not become earned surplus or undivided profits or invested capital, the stock dividend adding nothing to and taking nothing from invested capital. (LaBelle Iron Works v. U. S., decided June 28, 1920, Ct. of Cls. No. 34, 603, T. D. 3051, Treasury Bulletin 34-20-1158.

EFFECT OF LIQUIDATING DIVIDEND. An amount taken from capital or paid-in surplus to meet dividend requirements is deemed a liquidation of capital to that extent and necessitates

a reduction in the invested capital.[1] Thus, if a company pays a dividend declaring it to be out of earnings accumulated prior to March 1, 1913, and the excess of depletion allowable for 1917 upon the basis of the value of the company's property as of March 1, 1913, over the depletion actually estimated on the basis of cost, exceeds the dividend payment, the dividend payment will nevertheless be held to constitute an impairment of invested capital, even though the appreciation in value as of March 1, 1913, was converted into cash and reflected on the company's books during the current year. This appreciation, although it may have taken place prior to March 1, 1913, was not income until realized in the taxable year.[2] Under the excess-profits tax the earnings of the taxable year are not to be included in earned surplus and undivided profits, and the appreciation, therefore, cannot be taken into consideration to reduce or affect the impairment of invested capital occasioned by the dividend payment.[3]

[1] O. 942, Treasury Bulletin 26-19-598.
[2] Baldwin Locomotive Works v. McCoach, 221 Fed. 59.
[3] A. R. M. 51, Treasury Bulletin 20-29-43.

INCREASE OF CAPITAL STOCK. If the capital stock is increased during the taxable year, the invested capital will be considered to have been increased from and after the dates on which the cash or property for which such stock is issued are paid in.[1]

[1] See p. 687 of the 1920 edition.

REDUCTION OF CAPITAL STOCK. If the capital stock is reduced during the year, the invested capital will be considered to be reduced accordingly from and after the dates on which the assets representing such reduction of capital stock are paid to the stockholders.[1] The mere reduction of the authorized capital without a distribution of the assets will not affect the invested capital.

[1] See p. 687 of the 1920 edition.

PAYMENT OF PRECEDING YEAR'S EXCESS-PROFITS TAX. The amounts payable on account of income and excess-profits taxes for any year may be included in computing surplus and un-

divided profits for the succeeding year only for the proportionate part of the year represented by the period of time between the close of the taxable year and the date or dates upon which such taxes become due and payable.[1] The date when the 1918 taxes were *actually* paid has no bearing on the computation of the invested capital of a corporation for the year 1919, inasmuch as the controlling factor is the date when such taxes were due and payable, and not the date when they were actually paid. In other words, the amount of each installment of the tax for 1918 will remain a part of the invested capital for 1919 until such installment is due and payable, and when such installment is due, an adjustment should be made in the nature of a reduction of the book value of assets.[2] Income and excess-profits taxes are deemed to have been paid out of the net income for the taxable year for which such taxes are levied and it is immaterial whether or not a reserve was set up for such taxes and if set up, whether such taxes when paid have actually been charged against such reserves.[3] It seems immaterial whether or not sufficient earnings of the current year were on hand when such taxes were actually paid. In the case of corporations having a *fiscal* year, the Federal income and excess-profits taxes for the taxable year 1918 will, for the purpose of computing invested capital for the taxable year 1919, be deemed to become due and payable as follows: (a) As to such amounts as became due and payable prior to February 25, 1919, under the Revenue Act of 1916, such law shall govern; (b) In all other respects the Revenue Act of 1918 shall govern except that the installments which would become due prior to February 25, 1919, shall be deemed to become due and payable on that date; (c) Any amounts which became due and payable under the Revenue Act of 1916 prior to February 25, 1919, shall, so far as possible, be deemed to cancel the earlier installments payable under the Revenue Act of 1918.[4]

[1] Reg. 45, Art. 845; T. D. 2791.

[2] Letter from Treasury Department dated September 22, 1919; W. T. S. 1919, ¶ 1056.

[3] Reg. 45, Art. 845; T. D. 2791; O. D. 222, Treasury Bulletin 11-19-392.

[4] T. D. 2931; Reg. 45, Art. 845 (a); A. R. R. 81, Treasury Bulletin 45-20-1299. See Revenue Act of 1918, § 250; Revenue Act of 1916,

§ 14 (a). Under the Revenue Act of 1916, in the case of a fiscal year corporation, return was due within 60 days after the close of the fiscal year and tax was due within 105 days after the last due date of the return (not after the date of filing). hence, for the fiscal year ended August 31, 1918, the return was due on or before October 30, 1918, and the tax on or before February 12, 1919, or on or before the 165th day after August 31, 1918. The provisions of this (Reg. 45, Art. 845 (a)) apply solely for the purpose of computing invested capital and do not affect the provisions of T. D. 2797 in regard to the time and manner of paying taxes where corporations have filed returns for fiscal years ending in 1918. The rule stated in the text is illustrated as follows: For example, a corporation whose fiscal year ended August 31, 1918, is assessed a total income and profits tax under the 1917 Law of $250.000 and an additional tax under the 1918 Law of $110,000. The total tax of $360,000 would for the purpose of computing invested capital, be deemed to become due and payable as follows: February 12, 1919, $250,000; May 15, 1919, $20,000; August 15, 1919, $90.000. If, assuming the same taxes, the fiscal year ended September 30, 1918, the total tax would for the purpose of computing invested capital, be deemed to become due and payable as follows: February 25, 1919, $90,000; March 15, 1919, $90,000; June 15, 1919, $90,000; September 15, 1919, $90,000. (See Letter from Treasury Department dated October 27, 1919; W. T. S. 1919, ¶ 1059.)

Where a corporation has filed a claim for assessment of its 1918 tax by reference to representative corporations and has made payments on the basis of 50 per cent. of the net income, the claim not having been acted upon when its 1919 return is due, the invested capital for 1919 should be adjusted on the basis of the tax payments actually made, subject, however, to readjustment when the correct amount of tax for 1918 is determined.[5]

[5] O. D. 410, Treasury Bulletin 11-20-788.

EFFECT OF ADDITIONAL ASSESSMENT. The rule stated in the previous paragraph is in general applicable to additional assessments. It is the essence of any system of accrued accounting that items of income and outgo be estimated as they accrue and that the proper entries be made upon the books at that time. The books for any fiscal period are deemed to clearly reflect the history of that period and are not changed even though subsequent events demonstrate that certain accruals, to a minor degree, were incorrectly estimated. The

necessary adjustments to correct such errors are made in the current accounts. It is only where major adjustments are necessary that it is good accounting practice to make adjustments for past errors in the surplus account. For these reasons it has been recommended that additional assessments of income and excess profits taxes, for prior years which are relatively small or unimportant be considered paid from current earnings; but that where the additional assessment is relatively large and important such assessment be considered a liability of the taxable year in question and that the necessary adjustments of the surplus account be made. In such cases the phrase "due and payable" means the due date for taxes of the taxable year and not the date fixed for the payment of the additional assessment. In all cases in which the additional assessment is less than 5 per cent. of the original assessment or is less than $5,000 it will be considered paid out of current earnings and no adjustment of invested capital need be made.[1]

[1] T. B. M. 51, Treasury Bulletin 12-19-411.

REDUCTION OF RESERVES. If payments are made out of any reserves set up on the books of the company, which reserves are in fact a part of the surplus and have been included as invested capital at the beginning of the year, the invested capital is not reduced by such payments, if the payments are such as may properly be charged against the net income for the current year under the law. Thus if a corporation is carrying a self-insurance reserve and sustains a loss in 1919 due to fire or other casualty, it may deduct that loss against the 1919 income although on its books the loss may be charged against the reserve. In such case the reserve is not reduced for purposes of invested capital. If, however, payment is made out of the reserve for any expenditure which is not deductible from the 1919 income and does not represent investment in a new asset the reserve is reduced for purposes of invested capital.[1]

[1] See Reg. 45, Arts. 844 and 860.

Invested Capital for Fractional Part of Year. In the case of a corporation making a return for a full year of 12 months, its invested capital for the year is the average invested capital for the year. In the case of a corporation making a return for a fractional part of a year, its invested capital for such period is the same fractional part of the average invested capital for such period.[1] To illustrate: A corporation was organized July 1, 1918, and makes a return for the six months ending December 31, 1918. The invested capital consists of $100,000 paid in on July 1 and $100,000 paid in on October 1. The average invested capital for such period would be $100,000 plus 92/184 (not 92/365) of $100,000 or $50,000, a total of $150,000. The invested capital for the period for the purpose of the tax would, however, be 184/365 of $150,000, or $75,616.44.[2]

[1] For the purpose of § 311 (a) 2 of the statute it is the full average invested capital for the period.

[2] Reg. 45, Arts. 855, 856. In computing the tax under a return for a fractional part of a period the same purpose may sometimes be more readily effected by using the full invested capital and taking a fractional part of the result, as in schedule III of form 1120. In schedule IV of the same form, however, the fractional part of the full average invested capital for the period should be used.

Invested Capital for Prewar Period. The invested capital for the prewar period should in general be determined in the same manner as for the taxable year.[1] The determination of invested capital for the prewar period is important for purposes of computing the war-profits credit.[2] Since the war-profits tax is only temporary, being in force for the year 1918, except in the case of corporations deriving a net income of more than $10,000 from any government contract or contracts made between April 6, 1917, and November 11, 1918, both dates inclusive,[3] the following discussion of invested capital for the prewar period[4] relates only to the war-profits tax imposed on all corporations for the year 1918 and on corporations deriving

[1] Reg. 41, Art. 51; as to affiliated corporations see p. 708 of the 1920 edition.

[2] Revenue Act of 1918, § 311.

[3] Revenue Act of 1918, § 301 (c).

[4] See pp. 692-4, 695 of the 1920 edition.

incomes from government contracts, as above indicated,[5] for subsequent years.

[5] See pp. 649, 696 of the 1920 edition for further statement regarding this class of corporations.

ADJUSTMENT FOR ASSETS DIFFERENTLY VALUED IN PREWAR INVESTED CAPITAL.[1] In any case in which as a result of a reorganization or for any other reason any asset in existence both during the taxable year and any prewar year is included in computing the invested capital for the taxable year, but is not included in computing the invested capital of such prewar year, or is valued on a different basis in computing the invested capital for the two years, the difference resulting therefrom may not be included in determining the difference, 10 per cent. of which is added to or deducted from the war-profits credit. In any such case the corporation is required to make the readjustment required by the statute, and submit with its return a full statement of the difference in such valuations and of the facts which give rise to such difference.[2] This provision of the statute may operate in a case where a corporation was reorganized after the beginning of the prewar period, or consolidated with another, as a result of which good will, patents or other assets owned during the prewar period may have been capitalized for the first time, or the capital value of which may have been increased.

[1] The Revenue Act of 1917 was silent on this subject, and such adjustment was less important under that law.

[2] Revenue Act of 1918, § 330; Reg. 45, Art. 934.

REORGANIZATION AFTER JANUARY 1, 1911. In the case of the reorganization, consolidation or change of ownership after January 1, 1911, of a trade or business carried on during the taxable year by a corporation, the corporation will, for the purpose of determining invested capital for the war-profits credit, be deemed to have been in existence prior to that date and the net income and invested capital of such predecessor for all or any part of the prewar period up to the organization of the corporation now carrying on such trade or business will be deemed to have been the net income and invested capital

of such corporation. If the predecessor trade or business was carried on by a partnership or individual, the corporation must make its return of the net income and invested capital of such trade or business as nearly as may be in the same manner as if such trade or business had been carried on by a corporation. It should submit with its return a statement setting forth (a) the manner in which such trade or business was carried on and (b) the points, if any, in which the provisions of the statute and of the regulations are not fully applicable to the determination of the net income or invested capital of the predecessor trade or business for the prewar period. In no case shall the deduction from gross income for salary or compensation for personal services exceed the salaries or compensation customarily paid at that time by corporations or partnerships of similar size and standing engaged in similar trades or businesses for similar services under like responsibilities.[1]

In the case of a reorganization, the new corporation is required to base its invested capital on the adjusted balance sheet

[1] Revenue Act of 1918, § 330; Reg. 45, Art. 932. The 1917 Law contained a similar provision applicable to "a trade or business carried on by a corporation, partnership, or individual, although formally organized or reorganized on or after January 2, 1913, which is *substantially a trade or business* carried on prior to that date." A company owning a mill, some real estate and some water power rights and with two outstanding issues of bonds, became insolvent and stopped operations in June, 1914. The corporation was declared bankrupt in September, 1914. In March, 1915, a sale under the first mortgage was held and the property acquired on behalf of the first mortgage bondholders and a new corporation formed by the first mortgage bondholders which took over the assets of the old corporation from the trustee, the stock of the new corporation being divided among the first mortgage bond owners in proportion to their ownership of bonds. It was held that the business of the new company was substantially a continuation of the trade or business carried on by its predecessor because of the fact that the product manufactured by the new company was sold under the same trade name and produced in the same location, although the new company had made extensive changes in the water power and machinery, had installed at considerable expense some new machinery, had changed practically the entire system of production, had formed new banking connections, and had acquired additional funds through these connections for the purpose of securing additional working capital. (A. R. R. 221, Treasury Bulletin 32-20-1124.)

of its predecessor as of the date of reorganization. Appreciation in the value of the assets so transferred from the old organization to the new can not be included in the invested capital of the new corporation. The statute, however, does not prohibit the treatment of the date of reorganization as the beginning of a new taxable year. Consequently, it does not require the exclusion from the invested capital of the new corporation of surplus and undivided profits earned between the beginning of the then taxable year of the predecessor corporation and the beginning of the taxable year of the new corporation.[2]

[2] T. B. R. 2, Treasury Bulletin 1-19-137.

AVERAGE INVESTED CAPITAL FOR PREWAR PERIOD. The average invested capital for the prewar period is determined by first ascertaining the average invested capital for each year during the whole of which the corporation was in existence and averaging the sums so obtained.[1]

[1] Revenue Act of 1918, § 326 (d).

Invested Capital of Insurance Companies. The reserve funds of insurance companies the net additions to which are deductible from gross income[1] cannot be included in computing invested capital.[2]

[1] Revenue Act of 1918, § 234.

[2] Revenue Act of 1918, §§ 325, 326 (b); Reg. 45, Arts. 870, 569, 814. Under the 1917 Law it was held that the invested capital of a mutual insurance company would be deemed to consist of the sum of (1) any surplus or contingent reserves maintained for the general use of the business, plus (2) any legal reserves the net additions to which are included in the net income subject to the tax, making due allowance for inadmissible assets as required by the law. The invested capital of a stock insurance company was deemed to consist of its capital stock, paid-in or earned surplus and undivided profits, subject to the restrictive provisions regarding inadmissible assets, and computed in accordance with the provisions applying to the computation of invested capital of corporations. (Reg. 41, Art. 65.)

Invested Capital of Foreign Corporations. Inasmuch as the war-profits and excess-profits tax in the case of a foreign cor-

poration is not based on the invested capital of the corporation, but such corporations are assessed on the basis of representative corporations,[1] the rules for determining invested capital[2] have no application to foreign corporations. For the same reason, when rendering a return of income on form 1120 for a foreign corporation, no entry of invested capital should be made thereon.[3]

[1] See Revenue Act of 1918, §§ 327, 328.

[2] Revenue Act of 1918, § 326; Reg. 45, Arts. 831-870.

[3] Reg. 45, Arts. 871, 962. The 1917 Law provided that the invested capital of a foreign corporation would be determined by taking that proportion of the entire invested capital, as defined and limited by the law, which the net income from sources within the United States bore to the entire net income. (Revenue Act of 1917, § 207.) As a practical matter the Treasury Department found it extremely difficult to ascertain the invested capital of foreign corporations in this manner and ruled that where upon application by a foreign taxpayer it was found that the expense of securing the data necessary for the computation of the invested capital would be unreasonable in view of the amount of tax involved, or that it was impracticable to determine either the "entire invested capital" or the "entire net income," assessment would be made under § 210 of that law (Reg. 41, Art. 52) as a case in which the invested capital could not be satisfactorily determined.

War-Profits Credit.[1] In the case of all domestic corporations the war-profits credit includes a specific exemption of $3,000.

[1] Revenue Act of 1918, § 311; Reg. 45, Arts. 781-785.

MINIMUM WAR-PROFITS CREDIT. In all cases the minimum war-profits credit is an amount equal to 10% of the invested capital for the taxable year plus the specific exemption. This minimum exemption is allowed to any corporation which had no net income for the prewar period or whose net income for the prewar period was less than 10%.[1]

[1] Reg. 45, Art. 782.

WHERE INCOME IN PREWAR PERIOD WAS MORE THAN 10%. If the net income of a corporation for the prewar period was more than 10%, the average net income, determined by taking the total net income for the prewar period and dividing by the number of years during the whole of which the corporation

was in existence, even though there may have been no net income for one or more of such years, will be taken as a part of the war-profits credit. To this is added or deducted (depending upon whether or not the capital has been increased or reduced) 10% of the difference between the average invested capital for the prewar period and the invested capital for the taxable year.[1]

[1] Reg. 45, Art. 781; See illustration No. 1, Appendix to 1920 edition.

CORPORATIONS WHICH HAD NO PREWAR PERIOD. If a corporation had no prewar period, the war-profits credit is the specific exemption plus an amount equal to the same percentage of the invested capital of the taxpayer for the taxable year as the average percentage of net income to invested capital, for the prewar period, of corporations engaged in a trade or business of the same general class as that conducted by the taxpayer (but not less than 10% of the invested capital of the taxpayer for the taxable year). Such average percentage is to be determined by the Commissioner on the basis of data contained in the excess-profits tax returns filed under the Revenue Act of 1917. As such average percentage had not been determined and published at least thirty days prior to the time when the 1918 return of the taxpayer was due, such return was made up by using 10% as a deduction, but such average percentage when determined is to be used by the Commissioner in fixing the correct amount of the tax.[1] The average percentages of prewar income to prewar invested capital of general classes of corporations, grouped as to trades or businesses has now been published and is known as the "Median."[2] This median is final and relief will not be granted by way of special assessment with reference to representative corporations[3] merely for the reason that the application of the median does

[1] Revenue Act of 1918, § 311 (c).
[2] See the Appendix to the 1920 edition. The average known as the median is by the statute required to be used. It is not an arithmetic average but is found by taking the middle figure of a series or array of figures arranged in order from the lowest to the highest.
[3] Under Sections 327-328.

not fix the relief to which taxpayers think they are entitled.[4] If the majority of the stock of any corporation which had no prewar period is owned or controlled at any time during the taxable year by a corporation which had a prewar period, this provision does not apply and the war-profits credit will consist of the sum of the specific exemption of $3,000 and an amount equal to 10% of the corporation's invested capital for the taxable year.[5]

[4] A. R. R. 36, Treasury Bulletin 10-20-783.
[5] Revenue Act of 1918, § 311 (d); Reg. 45, Art. 784.

CORPORATIONS DERIVING INCOME FROM GOVERNMENT CONTRACTS. In the case of a corporation which had no prewar period and 50% or more of whose gross income consists of gains, profits, commissions, or other income derived from government contracts made between April 6, 1917, and November 11, 1918, both dates inclusive, the war-profits credit will consist of the sum of the specific exemption and an amount equal to 10% of the invested capital for the taxable year.[1]

[1] Revenue Act of 1918, § 311 (d); Reg. 45, Art. 784. It should be noted that this provision applies to all corporations which had no prewar period and one-half of whose income is derived from Government contracts or subcontracts (as defined in § 1 of the 1918 law—see p. 648 of the 1920 edition. In § 327 of the law, the restriction is limited to cases where the Government contracts provided for payment on a cost-plus basis. See p. 699 of the 1920 edition.

APPORTIONMENT OF WAR-PROFITS CREDIT IN CASE OF CORPORATION REPORTING FOR PART OF YEAR. If a return is made for a period of less than twelve months, the amount equal to the average net income for the prewar period plus or minus 10% of the difference between the average invested capital for the prewar period and the invested capital for the taxable year will be reduced to the same proportion thereof as the number of months in the period is of twelve months.[1]

[1] Reg. 45, Art. 781. The same result is reached in schedule IV of return form 1120 by computing the war-profits credit for a full year and taking a fractional part of the result.

FISCAL YEAR CORPORATIONS. In calculating a corporation's war-profits credit in the case of a fiscal year the starting

point for each year is the beginning of the fiscal year ending in 1911, 1912 and 1913, respectively, and the invested capital should be ascertained as at those dates. To these sums should be added any contributions of capital between the beginning of each such fiscal year and January 1, 1911, 1912 and 1913, respectively, and corresponding deductions should be made in respect of any dividends and any refunds of capital during those respective periods. To these balances should be added a pro rata share of the earnings of the respective fiscal years, and the totals thus arrived at will be deemed to be the invested capital of the taxpayer at January 1, 1911, 1912 and 1913, respectively. Taxpayers should file with their returns copies of their balance sheets at the beginning of each fiscal year and a schedule for each year showing the adjustments made in computing the invested capital as at the beginning of each calendar year during the prewar period. Where a taxpayer has such accounting records as will enable him to prepare an accurate balance sheet showing the true surplus and undivided profits at the beginning of each one of the prewar calendar years and an accurate income account for such years, he may make the computation upon this basis and explain the method used in such detail as will enable the Commissioner of Internal Revenue to determine whether such basis is proper. Where a taxpayer has not been in business during the whole of the prewar period the above methods will be applicable to such full calendar years during the whole of which years the taxpayer was in business.[1]

[1] T. B. R. 16, Treasury Bulletin 5-19-264.

Excess-Profits Credit. The excess-profits credit in the case of a domestic corporation consists of the specific exemption of $3,000 plus an amount equal to 8% of the invested capital for the taxable year.[1]

[1] Revenue Act of 1918, § 312; Reg. 45, Art. 791.

Specific Exemption. Domestic corporations are allowed a specific exemption of $3,000 to be deducted from the net income, but if the tax is computed for a period of less than twelve

months the specific exemption is reduced in proportion.[1] The specific exemption of $3,000 is apportioned only in the case where a return is made covering a period of less than twelve months. In such a case the specific exemption is the same proportion of $3,000 as the number of months in the period is of twelve months, any fractional part of a month being counted as the number of days in such part of a month divided by 30. Thus, in the case of a corporation organized May 12, 1918, and making a return for the period ending December 31, 1918, the exemption is $1,916.67, that is, the same proportion of $3,000 as 7 20/30 months is of 12 months. This provision is inapplicable where the return is made for a full fiscal year beginning prior to January 1, 1918, and ending after that date, even though the income for such fiscal year is not subject to full taxation under the present statute. In the case of affiliated corporations only one specific exemption is allowed.[2]

[1] Revenue Act of 1918, § 305.

[2] Reg. 45, Art. 761. On return form 1120 this apportionment is taken care of by prorating items 3 and 8 of schedule III.

Net Income. Net income for this tax is ascertained in general upon the same basis and in the same manner as for the purpose of the income tax except as noted in this and the following paragraphs. Reference to the rules for estimating income for the prewar period is given as well as the rules applying to the taxable year. Under the excess-profits tax, however, no attention need be paid to income during the prewar period but the rules for that period are given because they still apply to such corporations as by reason of deriving income from Government contracts of the kind hereinbefore indicated continue to be subject to the war-profits tax if their income from such contracts exceeds the sum of $10,000 in the taxable year. Corporations are not allowed at this late date to adjust salaries paid during the prewar period, when such adjustment is made solely for the purpose of increasing the war-profits credit for the taxable year.[1] Value appreciation of property taken up on the books of the taxpayer and returned as part

[1] T. B. M. 50, Treasury Bulletin 12-19-410; O. D. 184, Treasury Bulletin 8-19-319.

of his taxable income for the year in which the appreciation was written up must be excluded in computing prewar income, even though an income tax has been paid on it.[2] The rule that taxes are deemed to be paid out of earnings for the year for which levied, applies to any year of the prewar period as well as to the taxable year. In such cases the amount or amounts payable in a succeeding year on account of such taxes may be included in the computation of invested capital until due and payable.[3]

[2] T. B. M. 42, Treasury Bulletin 8-19-335.

[3] See Reg. 45, Art. 845; O. D. 222, Treasury Bulletin 11-19-392.

FOR THE YEARS 1911 AND 1912. The net income for these years is determined upon the same basis and in the same manner as provided in the 1909 Corporation Excise Tax Law except that the tax as imposed by that law and paid by the corporation within the year shall be included.[1] Including such taxes for the years 1911 and 1912 is a slight advantage to the corporation in that it increases the net income for the prewar period for the purpose of the war-profits credit.

[1] Revenue Act of 1918, § 320 (a) 1; Reg. 45, Art. 801.

FOR THE YEAR 1913. The net income for the year 1913 is ascertained on the same basis and in the same manner as provided in the 1913 Law except that the taxes imposed by the 1909 Corporation Excise Tax Law on the corporation on its income for 1912 and paid by the corporation in 1913 may be included, and amounts received by it as dividends upon the stock or from the net earnings of other corporations subject to the tax imposed by the 1913 Law, must be deducted.[1]

[1] Revenue Act of 1918, § 320 (a) 2; Reg. 45, Art. 801.

AVERAGE NET INCOME FOR THE PREWAR PERIOD. The average net income for the prewar period is determined by dividing the number of years within that period during the whole of which the corporation was in existence into the sum of the net income for such years, even though there may have been no

net income for one or more of such years.[1] Thus, if a corporation was in existence during 1912 and 1913 but derived no income in 1912, its income for the year 1913 must be divided by two in order to ascertain the war-profits credit. But, on the other hand, if the corporation had a deficit for the year 1912 and income for the year 1913, the amount of the deficit need not be deducted from the net income of 1913 in order to ascertain the average net income for the prewar period.[2]

[1] Letter from Treasury Department dated March 24, 1919; W. T. S. 1919, ¶ 1017.

[2] Letter from Treasury Department dated February 21, 1918. As to the prewar income of affiliated corporations, see p. 711 of the 1920 edition.

FOR THE TAXABLE YEAR. Net income for the taxable year is computed upon the same basis and in the same manner as provided for income tax purposes under the income tax law.[1] The law expressly provides that the net income of a corporation which is subject to the income tax shall also be subject to the excess-profits tax. This would include income derived from the sales or dealings in the capital assets of the taxpayer,[2] but in the case of the sale of mines, oil and gas wells a limitation is placed upon the amount of the excess-profits tax to be assessed with respect thereto.[3]

[1] Revenue Act of 1918, § 320 (a).

[2] Letter from Treasury Department dated February 21, 1918.

[3] See p. 655 of the 1920 edition. Under the 1917 Law the net income for purpose of income tax and excess-profits tax were not identical, since for the purpose of the latter tax corporations were expressly allowed to deduct dividends. Since the 1917 Law provided an excess-profits tax at lower rates on salaries than on income from a business employing invested capital, the Treasury Department held that where a corporation had paid its officers only nominal salaries, a reasonable allowance for salaries could be deducted for any period prior to March 1, 1918, if a satisfactory explanation was given. (Letter from Treasury Department dated March 11, 1918.) Under the present law there seems to be no need for a ruling of this character since an excess-profits tax law has been in force for a length of time sufficient to enable corporations to adjust salaries and other items which in the past may have been merely nominal by reason of the relation of the corporation to its stockholders.

Assessment Without Reference to Invested Capital. In certain cases it is found difficult or impossible to determine the invested capital of a corporation. In such cases and in cases of "abnormal conditions affecting the capital or income of a corporation," without reference to the difficulty or impossibility of determining invested capital in the ordinary manner, the excess-profits tax will be computed on the basis of the returns of representative corporations engaged in a like or similar trade or business.[1] Four cases in which the tax will be so determined are enumerated in the law and are discussed in the paragraphs below.

[1] Revenue Act of 1918, § 327. This section of the 1918 Law corresponds to the famous Section 210 of the 1917 Law which provided that when the invested capital could not be satisfactorily determined the corporation was entitled to an excess-profits deduction of an amount equal to the same proportion of its net income for the taxable year as the proportion which the average deduction (excluding the specific sum of $3,000) for the corresponding year of representative corporations bears to the total income of such representative corporations plus, in the case of domestic corporations, the sum of $3,000. This section applied also to partnerships and individuals under the 1917 Law. In determining this proportion the net incomes of representative corporations for the calendar year or for fiscal years ending in the calendar year were taken. In case the corporation whose invested capital could not be satisfactorily determined made a return for its own fiscal year the proportion determined for the calendar year ending during such fiscal year was used. (Reg. 41, Art. 24.) The rulings provided for a computation of constructive invested capital in order to apply the rates to a corporation whose invested capital could not be determined. (Reg. 41, Art. 18.) *Under the present law there is no need for constructive capital in such cases since the tax is now based upon the ratio of the amount of tax to the amount of net income of representative corporations.*

ELECTION OF TAXPAYER. It has been held under the corresponding section[1] of the Revenue Act of 1917 that while a strict and literal interpretation of the language gives the Treasury Department the right to determine that invested capital can not be satisfactorily determined, and therefore that the taxpayer should be assessed without reference to invested capital, it is manifestly the intent of the law that the tax-

[1] Revenue Act of 1917, § 210.

payer shall have a deduction upon all the statutory invested capital which he can establish, and if in any case the taxpayer is able to show that it has statutory invested capital in excess of constructive capital found upon application of the special relief section the taxpayer should not be deprived of the right to have assessment based upon such statutory capital because there are other items of invested capital which can not be determined and which the taxpayer concedes the right of the Treasury Department to ignore. This rule would seem to apply under the Revenue Act of 1918 except with regard to foreign corporations.[2]

[2] A. R. R. 209, Treasury Bulletin 31-20-1111. No constructive invested capital is found under the 1918 Law.

Where Commissioner Is Unable to Determine Invested Capital. The first case is where the Commissioner is unable to determine invested capital as defined in the law. Such cases exist, for example, where the books of account of the company have not been kept in proper form or where it is impossible to ascertain the values of assets at the time of acquisition.[1]

[1] Revenue Act of 1918, § 327 (a). The 1917 Law (Section 210) provided a method which should be followed in all cases in which the Commissioner was unable *satisfactorily* to determine the invested capital. In the language of the present law the word "satisfactorily" was omitted.

INVENTIONS TURNED OVER TO CORPORATION WITHOUT CONSIDERATION. In a case in which the principal stockholder turned over, without consideration, to a close corporation an invention in respect to which a patent was subsequently granted after some litigation, it was ruled that the company was entitled to assessment with reference to representative corporations on the ground that the value of the invention at the time turned over and before commercial development could not be satisfactorily determined. Had it been possible satisfactorily to determine such value, the proper procedure would have been to recognize such value as paid-in surplus.[1]

[1] A. R. R. 70, Treasury Bulletin 17-20-882.

In the Case of Foreign Corporations. The Revenue Act of 1918 provides that, in the case of foreign corporations, the tax shall be determined without reference to invested capital as defined in the law.[1] In the case of a foreign corporation carrying on all of its business in the United States it does not seem that the law should prevent the corporation from obtaining such benefits as may accrue to it from a computation of the credits with reference to an invested capital determined in the ordinary manner, but the language of the provision that the tax shall be assessed by reference to representative corporations indicates an intent that this method of assessment shall apply to all foreign corporations, and the Treasury Department has so ruled.[2]

[1] Revenue Act of 1918, § 326.
[2] Revenue Act of 1918, § 327; Reg. 45, Art. 871.

Where Stock Has Been Issued for a Mixed Aggregate of Tangible and Intangible Property. The provision of the law that the tax shall be assessed by reference to representative corporations where a mixed aggregate of tangible property and intangible property has been paid in for stock or for stock and bonds, does not apply in all cases where a mixed aggregate of tangible and intangible property has been paid in for stock or for stock and bonds, but only in such cases where the Commissioner is unable satisfactorily to determine the respective values of the several classes of property at the time of payment, or to distinguish the classes of property paid in for stock and for bonds respectively.[1]

[1] Revenue Act of 1918, § 327 (c). Under the 1917 Law it was ruled that assessment would be made under section 210 of that law in cases where the Secretary was unable to determine satisfactorily the respective values of the several classes of property at the time of payment. (Reg. 41, Art. 52.) This provision of the law seems to be a statutory declaration of the rule adopted by the Treasury Department as a matter of practice.

Cases of Abnormal Conditions Affecting Capital or Income. In cases of abnormal conditions affecting the capital or income of a corporation, assessment without reference to invested

capital is intended to operate as a remedial measure as distinguished from cases where it is difficult or impossible to determine invested capital. Such assessment is made only upon application by the corporation in cases where, upon such application, the Commissioner finds (and so declares of record) that the tax if determined without the benefit of this section would, owing to abnormal conditions affecting the capital or income of the corporation, work upon the corporation an exceptional hardship evidenced by gross disproportion between the tax computed without the benefit of this section and the tax computed by reference to representative corporations. This provision does not apply to any case (1) in which the tax based upon the corporation's invested capital is high merely because the corporation earned a high rate of profit upon a normal invested capital nor (2) in which 50% or more of the gross income of the corporation for the taxable year consists of gains, profits, commissions or other income derived *on a cost plus basis* from a Government contract or contracts made between April 6, 1917, and November 11, 1918, both dates inclusive.[1] It may apply, however, to a corpora-

[1] Revenue Act of 1918, paragraph 327 (d). The limitation stated in (1) above is applicable to assessments under section 210 of the 1917 Law (T. B. M. 7, Treasury Bulletin 1-19-119.). Under the 1917 Law the following were held to be exceptional cases which warranted assessment under Section 210 of that law.

(1) Where, through defective accounting or lack of adequate data, it was impossible accurately to compute invested capital.

(2) Where upon application by a foreign taxpayer the Secretary of the Treasury found that the expense of securing the data necessary for the computation of the invested capital would be unreasonable in view of the amount of tax involved, or that it was impracticable to determine either the "entire invested capital" or the "entire net income."

(3) Long established business concerns which by reason of ultraconservative accounting or the form and manner of their organization would otherwise be placed at a serious disadvantage in competing with representative concerns in a like or similar trade or business.

(4) Where the invested capital was seriously disproportionate to the taxable income. Such cases it was held might arise through (a) the realization in one year of the earnings of capital unproductively invested during a period of years or the fruits of activities antedating the taxable year; or (b) inability to recognize or properly allow for amortization, obsolescence, or exceptional depreciation due to the war.

or to the necessity in connection with the war of providing plant which would not be wanted for the purpose of the business after the termination of the war. (Reg. 41, Art. 52.) The uses enumerated in this article are not to be regarded as exclusive, but the class of cases therein referred to is limited to the cases enumerated or those "similar in character." (T. B. M. 58, Treasury Bulletin 14-19-441.) Under the present law the conditions described in 1 and 2 are expressly provided for; 3 and 4 (a) will probably be considered as creating "abnormal conditions affecting the capital or income" within the meaning of Section 327 (d) and therefore entitle the corporation to relief. The condition stated in 4 (b) no longer exists as the present law enables the taxpayer to recognize and properly allow for amortization, obsolescence or exceptional depreciation.

tion deriving income from government contracts on the "per unit" basis.[2] The limitation stated in (2) above has been held to be designed to cover cases in which a contractor was assured of a profit irrespective of cost and in which the Government, rather than the contractor, assumed the risk of loss.

Where the unfinished work of a contractor was commandeered by the Government and it was agreed that he should receive the same compensation as he would have received under the private contract, the fact that he was subsequently compensated on a cost-plus basis after the work was completed does not, in the opinion of the Committee, operate to change the legal situation in this respect.[3]

The tax will not *ordinarily* be assessed under this provision of law merely because the corporation's form or manner of organization, or the limitations as to invested capital result in a greater tax than would otherwise be payable. Referring to the legislative history of the Revenue Act of 1918, it will be noted that this provision of the statute as enacted by the Senate read as follows: "(e) Where the invested capital is materially disproportionate to the net income as compared with representative corporations engaged in a like or similar trade or business because: 1. The capital employed, although a material income-producing factor, is very small or is in large part borrowed. 2. There are excluded from the invested capital as computed under the provisions of section 326, intangible

[2] O. D. 321, Treasury Bulletin 26-19-599.

[3] A. R. M. 89, Treasury Bulletin 45-20-1288.

assets of recognized and substantial value built up or developed by the taxpayer. 3. The net income for the taxable year is abnormally high due to the realization in one year of (a) gains, profits, or income earned or accrued during a period of years or (b) extraordinary gains or profit derived from the sale of property the principal value of which has been demonstrated by prospecting or exploration and discovery work done by the taxpayer. When the tax is determined under this paragraph proper allowance shall be made for the taxes which would have been payable in prior years if the gains, profits, or income earned or accrued in such years had been taxed at the rates then applicable. 4. Proper recognition or allowance can not be made for amortization, obsolescence, or exceptional depreciation due to the present war, or to the necessity in connection with the present war of providing plant which will not be wanted for the purpose of the trade or business after the termination of the war." This provision was stricken out by the Conference Committee and in its place is inserted the vague phrase "abnormal conditions affecting the capital or income of a corporation."[4] It seems probable that the instances enumerated in the Senate bill as above quoted are contemplated by the phrase of the law as finally passed—abnormal conditions affecting the capital or income of the corporation—and that the Conference Committee used the broad language enacted in the statute as finally passed because of the possibility that in defining the operation of the provisions for assessment of the excess-profits tax by reference to representative corporations it would be limiting the Commissioner in the exercise of his discretion and possibly preventing him from granting relief in many cases which could not be exactly anticipated or defined by Congress at the time the law was enacted. It is a well-established principle of statutory construction that where the language of the statute is ambiguous and its meaning doubtful, the bill as introduced and changes made in the frame of the bill in the course of its pass-

[4] This provision was in large part a statutory enactment of the Treasury Department's previous liberal construction of Section 210 of the Revenue Act of 1917. Compare the provision with the regulation quoted in note 198 of the 1920 edition.

age may be resorted to upon questions of legislative intent.[5] The above language of the Senate bill should be consulted in connection with applications for relief by way of assessment with reference to representative corporations.

[5] U. S. v. St. Paul M. R. Co., 247 U. S. 310, 318; Atl. C. L. R. Co v. Riverside Mills, 219 U. S. 196, 200. See also cases cited in chapter 47 of 1920 edition.

WHERE INTANGIBLE ASSETS OF SUBSTANTIAL VALUE ARE EXCLUDED FROM ORDINARY INVESTED CAPITAL. Under the Revenue Act of 1917 relief was given to many long established business concerns which, by reason of ultra-conservative accounting or the form and manner of their organization, would otherwise have been placed at a serious disadvantage in competing with representative concerns in a like or similar trade or business.[1] As stated in the foregoing paragraph, the fact of ultra-conservative accounting and the form and manner of the corporation's organization will not *ordinarily* entitle a taxpayer to special assessment.[2] It seems clear, however, that the Revenue Act of 1918[3] contemplates that relief be granted where such factors misrepresent a corporation's true invested capital. Thus, cases in which large sums have been spent in advertising, thus creating a goodwill or earning capacity far in excess of recognizable invested capital are to be regarded as cases in which there are abnormal conditions affecting invested capital.[4] A corporation, the capitalization of which did not represent or include the value of certain goodwill or patents actually turned over to the company and actually earning income on which the corporation was paying a tax, has been held taxable under the provisions of Section 210 of the Revenue Act of 1917.[5]

[1] See Reg. 41, Art. 52.
[2] See Reg. 45, Art. 901.
[3] Sec. 327 (d).
[4] A. R. M. 12, Treasury Bulletin 2-20-679.
[5] A. R. R. 110, Treasury Bulletin 20-20-945.

WHERE ABNORMAL PROFITS ARE THROWN INTO A SINGLE TAXABLE YEAR. The artificiality of the taxable year as a unit of time for tax purposes is generally conceded. The year

is taken as a matter of necessity because the very nature of income demands that it be measured by reference to time.[1] The taxable year works fairly well as a time unit in the majority of cases. The injustices, inequalities and absurdities resulting in extraordinary cases, however, are generally conceded.[2] It is well-known that one of the purposes of provision for assessment by reference to representative corporations is to provide for cases in which a hardship of this kind occurs. Such hardship may occur, broadly speaking, in one of two ways. In the first place, it may occur when the income of the taxable year represents the "realization in one year of the earnings of capital unproductively invested for a period of years, or the fruits of activities *antedating* the taxable year." This kind of a case was specifically provided for in the regulations issued under the Revenue Act of 1917.[3] In the second place, it may also occur when the income of the taxable year represents temporary earnings inevitably to be reduced by then indeterminable losses inseparably connected with the production of such income. While this class of cases has nowhere been enumerated in a formal regulation, it seems to be clearly analogous in principle to the class of cases described in the above quotation and must have arisen in the case of many corporations operating under long-term, fixed-price contracts during the last few years when the cost of labor and materials was constantly rising. It might also arise in the case of a company which liquidated all its business in a particular year although in the only decision made by the Treas-

[1] No one has income at any one point of time; he has income only by reference to a fixed period (Trefry v. Putnam (Mass.), 116 N. E. 904).

[2] See letter of former Secretary of Treasury to Committee on Ways and Means of House of Representatives (66th Congress, 1st Session) dated November 3, 1919, in which it is said that the annual accounting period, the striking of a balance of gain or loss every twelve months, is merely an approximation resting upon convenience and fiscal necessity, and that the result shown is frequently unreal, for if a business concern makes $20,000 in 1918, loses $10,000 in 1919, and makes $5,000 in 1920, it has not earned profits of $25,000 in the three-year period, but only $15,000.

[3] Reg. 41, Art. 52.

ury Department upon this point, the liquidation did not result in a tax abnormally high as compared with taxes imposed upon representative concerns in the same line of business.[4]

[4] T. B. M. 53, Treasury Bulletin 15-19-453; see O. D. 395, Treasury Bulletin 5-20-723 and T. B. M. 60, Treasury Bulletin 15-19-454 in which it is said that the abnormal income may arise through a sale of capital assets.

PAYMENT OF INADEQUATE SALARIES TO OFFICERS. It has been held under the Revenue Act of 1917 that failure to pay salaries to officers, or the payment of unusually low salaries in comparison with salaries paid to the officers of competing concerns, may create an abnormality of income which will entitle a corporation to special assessment.[1]

[1] A. R. R. 326, Treasury Bulletin 47-20-1318.

ABNORMAL CONDITIONS AFFECTING PREWAR PERIOD. The statutory provision in regard to "abnormal conditions" is not in terms limited in its application to cases arising out of abnormal conditions affecting the capital or income of the corporation *for the taxable year.* The words "capital or income of the corporation" are general words applicable to the income or capital of any year and can not be limited by construction unless there is a clear, necessary, and irresistible implication from other parts of the statute that such a limitation should be made.[1] Furthermore, in the same subdivision Congress has in two instances specified that the income or profits referred to is that of the taxable year, although the context made that meaning clear without specification. The use of such a limiting clause in two instances and the absence of it in the third instance indicates that the words were there used without limitation. Therefore, unless there is some clear and necessary inference from the other parts of the statute, it seems evident that subdivision (d) includes cases of hardship caused by abnormal conditions affecting the capital or income for the prewar period. The prewar data is used in

[1] Faw v. Marsletter, 3 Cranch. 10, 23; U. S. v. Coombs, 12 Peters 72, 80.

computing the war profits credit which may consist of (a) $3,000 plus the average net income for the prewar period with an adjustment for change in capital; or (b) $3,000 plus a percentage of the invested capital for the taxable year based on the median average established by the prewar experience of a general class of trade or business. This credit is used by concerns having no prewar period; or (c) a minimum war profits credit of $3,000 plus 10% of the invested capital for the taxable year.[2] The minimum war profits credit will not raise a presumption that Congress intended to include in section 311 all relief which should be granted because of abnormal conditions existing in the prewar period, and that there is a clear and necessary inference that Congress did not intend to grant further relief of the same nature under section 327 on account of the same conditions. The relief granted by the maximum war-profits credit and special assessment are not of the same nature. The minimum war-profits credit establishes certain rules applicable to general classes and which apply in all cases whether hardship actually exists or not. It gives relief to industries which passed through a period of depression in the prewar years. It also applies to concerns which earned less than 10% in the prewar period, even though their tax is not grossly disproportionate to that of their competitors. The "abnormal conditions" provision, on the other hand, deals not with general classes but with specific instances and grants relief in special cases according to the facts of each case where, without such relief, there would be a hardship as compared with representative concerns because of some abnormal condition affecting the capital or income of the corporation. The two provisions are of a different nature. The one would give no relief to a corporation belonging to a class which normally earned 20% if that corporation, due to some abnormal condition affecting the income of the prewar period, earned only 12% during the prewar period. Such concerns do not receive even partial relief under the minimum war-profits credit and should be granted relief under the "abnormal conditions" pro-

[2] Revenue Act of 1918, § 311.

vision.[3] It has been held under the 1917 law that a corporation, which in 1911 commenced the erection and operation of a refinery, the building of which and the experimental operation and development work connected with which extended over several years, requiring the withdrawal from other lines of the corporation's business of a large share of its available capital, thus temporarily curtailing its earning power and reducing its profits, and thus rendering the prewar period abnormal and not a true measure of the corporation's normal average business, should be assessed under the provision requiring the excess-profits deduction to be an amount equal to the same percentage of invested capital for the taxable year which the average deduction for such year of representative corporations is of the average invested capital for such year plus, in the case of a domestic corporation, $3,000.[4] Under the Revenue Act of 1918 this kind of relief would seem to be contemplated under the general provision for assessment by reference to representative corporations on the ground that abnormal conditions affected the capital or income of the pre-war period.

[3] O-1000-A, Treasury Bulletin 19-20-922, reversing O-1000.

[4] Revenue Act of 1917, Section 205; A. R. R. 104, Treasury Bulletin 20-20-944.

STATEMENT TO BE FILED. A corporation the income or capital of which is affected by abnormal conditions may make application for assessment by reference to representative corporations, which application should be attached to its return in the form of a statement setting forth in full: (a) the reasons why the tax should be so determined; (b) the facts upon which such reasons are based; (c) an exact description of each trade or business or important branch of a trade or business carried on by it; (d) a statement of the invested capital and net income for each year since the beginning of the prewar period; and (e) a statement showing the amount of gains, profits, commissions or other income derived on a cost plus basis from Government contracts made after April 5, 1917,

and before November 12, 1918, and showing the percentage which such income is of the total income of the corporation.[1]

[1] Reg. 45, Art. 901.

Method of Assessment. Under the method of assessment by reference to representative corporations the tax will be an amount which bears the same ratio to the net income of the taxpayer (in excess of the specific exemption of $3,000) for the taxable year, as the average tax of representative corporations engaged in a like or similar trade or business, bears to their average net income (in excess of the specific exemption of $3,000) for such year. In the case of a foreign corporation the tax is computed without deducting the specific exemption of $3,000 either for the taxpayer or the representative corporations.[1] Illustration: If the average net income of representative corporations is represented by $100,000, the net income in excess of the specific exemption would be $97,000. If the average tax is found to be $38,800, the rate to be applied to domestic corporations will be 38,800÷97,000 or 40%. Thus, a domestic corporation having a net income of $60,000 will deduct the specific exemption of $3,000, leaving $57,000—40% of which is $22,800, the amount of tax due under this section. But if the corporation is a foreign corporation and has an income of $60,000 the tax rate will be determined by dividing 38,800 by 100,000 which decreases the percentage to 38.8%. But this is applied to the entire net income, $60,000, making the tax due from the foreign corporation $23,280, or $480 more than that imposed on a domestic corporation with the same net income.

In the case of a corporation with a fiscal year ending in 1918, the tax is computed first as if the entire income had been earned during the calendar year 1917 and second as if such entire income had been earned during the calendar year 1918. The proper proportions of the resulting taxes are used to determine the tax for the fiscal year. "Constructive" invested

[1] Revenue Act of 1918, § 328 (a). This method is much simpler than that prescribed by Section 210 of the 1917 Law and reaches approximately the same result.

capital is used only with respect to the first computation, the method with respect to the second computation being to fix a tax bearing the same ratio to net income as the taxes of representative corporations.[2]

[1] Revenue Act of 1918, § 335 (a); T. B. M. 30, Treasury Bulletin 6-19-285. The provisions of Section 210 as interpreted by Article 52 of Regulations 41 and Section 327 are somewhat different and it is possible that a corporation may be entitled to special assessment under the 1917 Law and not under the 1918 Law, or *vice versa.* In such case it would seem that the tax would be computed as follows: First, as if the entire net income had been earned during the calendar year 1917, the tax being computed thereon under Section 210; second, as if the entire net income had been earned during 1918, the tax thereon being computed under Section 301. These taxes, one computed by special assessment and the other computed in the ordinary manner, would then be divided into their proper proportions to determine the tax for the fiscal year.

Representative Corporations. The representative corporations with respect to which the tax is to be computed under this section are those corporations whose invested capital can be satisfactorily determined in the ordinary manner and which are, as nearly as may be, similarly circumstanced with respect to gross income, net income, profits per unit of business transacted and capital employed, the amount and rate of war-profits or excess-profits, and all other relevant facts and circumstances.[1] In each case the Commissioner will determine, as nearly as may be, the group or class of corporations with which the corporation should be compared.[2]

[1] Revenue Act of 1918, § 328 (a).

[2] Reg. 45, Art. 911. It seems that the following should be considered in selecting representative corporations: (1) a representative corporation should be fairly representative of all corporations engaged in the same general line of business, as that of the corporation seeking the assessment under this provision of the law; (2) it should operate in the same general vicinity; (3) it should approximate in gross sales, gross earnings, and net earnings; (4) it should approximate as to manner and form of organization, especially financing; and (5) it should have been in business for approximately the same length of time.

Ratio Between Average Tax and Average Net Income. The ratio between the average tax and the average net income of

representative corporations is to be determined by the Commissioner in accordance with regulations prescribed by him with the approval of the Secretary.[1]

[1] Revenue Act of 1918, § 328 (b).

Payment of Tax by Corporations Applying for This Assessment. In cases in which the tax is to be computed without reference to the invested capital, the corporation is required to pay its tax in installments without the benefit of the section, if the tax as so computed is less than 50% of the net income of the taxpayer. But if the tax so computed is 50% or more of the net income the installments to be paid by the corporation must be computed in the first instance upon the basis of a tax equal to 50% of the net income. The installments of the tax are provisionally computed as provided in the following paragraphs. These installments are paid until the Commissioner notifies the corporation of the amount of tax as computed without reference to invested capital. In any case, the actual ratio when ascertained will be used in determining the correct amount of the tax. If the correct amount of the tax when determined exceeds 50% of the net income any excess of the correct installments over the amounts actually paid will become due and payable ten days after notice and demand together with interest at the rate of one-half of one per cent. per month on such excess from the time the installment was due. If, on the other hand, the correct determination of the amount of the tax is less than the amount on which installments have been paid the law impliedly provides that the amount so paid shall either be credited to the installments falling due after final determination, or if all the installments have been paid before the tax is finally determined the amount will be refunded in the usual manner.[1] No interest however will be paid to the taxpayer on excess amounts paid in the first instance. It is not permissible to file a bond in lieu of cash payments on a 50% basis pending final determination of tax due.[2] The Treasury Department requires every corporation of this

[1] Revenue Act of 1918, Section 328; Reg. 45, Art. 914.
[2] O. D. 94, Treasury Bulletin 1-19-136.

class which claims special assessment *subsequently* to assessment in the ordinary manner to file a claim for abatement on Form 47 for the excess over 50% of its net income. No such abatement claim need be filed if special assessment is claimed when the return is filed.[3]

[3] O. D. 356, Treasury Bulletin 31-19-655, modifying letter from Treasury Department dated October 15, 1919; W. T. S. 1919, paragraph 1058.

DETERMINATION OF FIRST INSTALLMENT OF TAX IN SPECIAL CASES. In the case of any corporation, other than a foreign corporation, where absolutely no data are available for the determination of the invested capital for the taxable year, the installments of the tax will be determined in the first instance upon the basis of a war-profits and excess-profits tax equal to 50% of the net income. In any other case in which application is made for assessment by reference to representative corporations, other than the case of a foreign corporation, but including a case where the invested capital for the taxable year can not be accurately determined, but where a minimum amount of invested capital as to which there is no question can be determined, the installments will be determined in the first instance upon the basis of a war-profits and excess-profits tax computed by using the minimum invested capital, such tax not to exceed an amount equal to 50% of the net income.[1]

[1] Reg. 45, Art. 912.

DETERMINATION OF FIRST INSTALLMENT OF TAX IN THE CASE OF FOREIGN CORPORATION. In the case of a foreign corporation the installments of the tax will be determined in the first instance upon the basis of a war-profits and excess-profits tax computed by using its invested capital for the taxable year 1917, such tax not to exceed 20% of the amount of the income in excess of $3,000 and not in excess of $20,000 plus 40% of the next income in excess of $20,000. For this purpose the invested capital for 1917 will be adjusted for any subsequent changes in its amount, due to cash or property paid in or withdrawn or to surplus or undivided profits of prior years retained in the business and properly attributable to its

business within the United States. If the tax for 1917 was determined by assessment with reference to representative corporations, the constructive capital which would result in a tax equivalent to the tax so determined will be used.[1]

[1] Reg. 45, Art. 913; O. D. 402, Treasury Bulletin 6-20-735.

Commissioner to Keep Record. The Commissioner is required to keep a record of all cases in which the tax is determined without reference to invested capital containing the name and address of the taxpayer, the business in which engaged, the amount of invested capital and net income shown by the return.[1] The Commissioner is required to furnish a copy of such record and other detailed information with respect to such cases when required by resolution of either House of Congress without regard to the restrictions usually imposed upon him with respect to divulging information contained in income tax returns.[2]

[1] The law also requires this record to show the amount of invested capital as determined under subdivision (a) of Section 328, but that subdivision does not call for a determination of invested capital and hence this requirement is meaningless.

[2] Revenue Act of 1918, § 328 (c).

Incorporation of Business of Partnership or Individual. In the case of the organization as a corporation before July 1, 1919,[1] of any business in which capital is a material income-producing factor and which was previously owned by a partnership or individual, the net income of such trade or business from January 1, 1918, to the date of such reorganization may at the option of the individual or partnership be taxed as the net income of a corporation for income tax, excess-profits and war-profits tax purposes. No taxpayer can be entitled to the benefits of the third paragraph of section 330 unless a corporation *de jure* or *de facto* came into existence prior to July 1, 1919.[2]

[1] There is no authority in the Treasury Department to extend the time within which to effect this reorganization (O. D. 223, Treasury Bulletin 11-19-393).

[2] O. 1023, Treasury Bulletin 16-20-872. The intention to incorporate, the execution and mailing of the articles of incorporation to the Secre-

tary of State on June 30, 1919, the opening of corporate books as at June 30, 1919, and the manufacturing for one day under the same name used hitherto, in the absence of other proof of user prior to July 1, 1919, does not justify the inference that a corporation *de facto* existed before July 1, 1919.

If the individual or partnership chooses to adopt this method of taxation the net income and invested capital must be computed as if the corporation had been in existence on and after January 1, 1918, and in such cases, (1) amounts distributed on or after January 1, 1918, from the earnings will be taxed to the recipients as dividends; (2) all the provisions of the income tax and the war-profits and excess-profits tax sections of the law relating to corporations will so far as practicable be applied to such trade or business; (3) the trade or business will be subject to the capital stock tax imposed by Section 407 of the Revenue Act of 1917 and Section 1000 of the Revenue Act of 1918, as if such taxpayer had been a corporation on and after January 1, 1918, with a capital stock having no par value; (4) the undistributed profits or earnings of such taxpayer will not be subject to the surtax. The adoption of any other date than January 1, 1918, for such purpose is not permissible. This option to be taxed as a corporation does not apply to any trade or business the net income of which for the taxable year 1918 was less than 20% of its invested capital for such year.[3] In a case in which the partnership net income was more than 20% of its invested capital but the net income of the partnership, taken together with the net income of three corporations, 99% of the stock of which was owned by the partnership, was not over 20% of the invested capital of the partnership and the corporation, the partnership was not denied the benefit of this provision.[4] Partnership net income as above contemplated means net income after deducting salaries of partners.[5]

[3] Revenue Act of 1918, § 330; Reg. 45, Art. 933.
[4] T. B. R. 27, Treasury Bulletin 6-19-286.
[5] O. D. 95, Treasury Bulletin 1-19-1381.

CONDITIONAL LIBERTY BOND EXEMPTION OF REORGANIZED CORPORATION. If a partnership was an "original subscriber" to Liberty bonds of the fourth series and was reorganized as a

corporation prior to July 1, 1919, and elects to be taxed as a corporation from January 1, 1918, it will be considered as an "original subscriber" to such Liberty bonds within the meaning of the $45,000 exemption "conditional on original subscription to, and continued holding at the date of the tax return of, two-thirds as many bonds of the Fourth Liberty Loan". The same considerations apply to the $20,000 exemption "conditional upon original subscribing to, and continued holding at the date of the tax return of, one-third as many notes of the Victory Liberty Loan".[1]

[1] O. D. 211, Treasury Bulletin 11-19-373; see also Reg. 45, Art. 79.

Affiliated Corporations. The invested capital of affiliated corporations[1] for the taxable year is the invested capital of the entire group treated as one unit operated under a common control. As a first step in the computation a consolidated balance sheet should be prepared in accordance with standard accounting practices, which will reflect the actual assets and liabilities of the affiliated group. In preparing such a balance sheet all intercompany items, such as intercompany notes and accounts receivable and payable, should be eliminated from the assets and the liabilities, respectively, and proper adjustments should be made in respect of intercompany profits or losses reflected in inventories which at the beginning or end of the taxable year contain merchandise exchanged between the corporations included in the affiliated group at prices above or below cost to the producing or original owner corporation. Such consolidated balance sheet will then show (a) the capital stock of the parent or principal company in the hands of the public; (b) the consolidated surplus belonging to the stockholders of the parent or principal company; and (c) the capital stock, if any, of subsidiary companies not owned by the parent or principal company, together with the surplus, if any, belonging to such minority interest. In computing consolidated invested capital the starting point is furnished by the total of the amounts shown under (a), (b) and (c) above. This total must be in-

[1] See p. 162 of the 1920 edition.

creased or diminished by any adjustments required to be made under the provisions relating to invested capital.[2]

[2] Reg. 45, Art. 864.

INTANGIBLE PROPERTY PAID IN. The following rules govern the inclusion of intangible property in invested capital of affiliated corporations: (1) In respect of corporations whose affiliation is in the nature of parent and subsidiary companies: (a) in the case of intangible property *bona fide* paid in for stock or shares prior to March 3, 1917, there may be included in invested capital an amount not exceeding the actual cash value of such property at the time paid in or the par value of the stock or shares issued therefor, or in the aggregate 25 per cent. of the par value of the total stock or shares of the consolidation outstanding on March 3, 1917 (determined as indicated in items (a) and (c) of the preceding paragraph), or in the aggregate 25 per cent. of the par value of the total stock or shares shown on the consolidated balance sheet, being the amount of the capital stock included in items (a) and (c) in the preceding paragraph, at the beginning of the taxable year, whichever is lowest; and (b) in the case of intangible property *bona fide* paid in for stock or shares on or after March 3, 1917, there may be included in invested capital an amount not exceeding the actual cash value of such property at the time paid in, or the par value of the stock or shares issued therefor, or in the aggregate 25 per cent. of the par value of the total stock or shares shown by the consolidated balance sheet, being the amount of the capital stock included in items (a) and (c) in the preceding paragraph outstanding at the beginning of the taxable year, whichever is lowest. (c) When intangible property has been acquired in part before and in part after March 3, 1917, the amounts shall be ascertained, respectively, under (a) and (b) above and in the aggregate shall in no case exceed 25 per cent. of the par value of the total stock or shares outstanding at the beginning of the taxable year shown in the consolidated balance sheet, being the amount of the capital stock included in items (a) and (c) in the preceding paragraph. (2) In respect of corporations affiliated by reason of ownership

by the same interests, the limitations with respect to the inclusion of intangible property in invested capital set forth in paragraphs (4) and (5) of subdivision (a) of Section 326 of the statute shall be applied to each corporation separately and the aggregate of the intangible property, so valued, shall be included in invested capital in the consolidated return. In respect of each of the affiliated corporations the aggregate of the amounts ascertained under the provisions of paragraphs (4) and (5) shall in no case exceed 25 per cent. of the outstanding capital stock of such corporation at the beginning of the taxable year.[1]

[1] Reg. 45, Art. 865.

INADMISSIBLE ASSETS. Where adjustment is required in respect of inadmissible assets, such adjustment must be made on the basis of the consolidated balance sheet with due regard to the adjustments and eliminations set forth in the preceding paragraphs and the general provisions relating to inadmissible assets.[1]

[1] Reg. 45, Art. 866.

STOCK OF SUBSIDIARY ACQUIRED FOR CASH. When all or substantially all of the stock of a subsidiary corporation was acquired for cash, the cash so paid will be the basis to be used in determining the value of the property acquired.[1]

[1] Reg. 45, Art. 867; T. D. 2901, modifying T. D. 2662.

STOCK OF SUBSIDIARY ACQUIRED FOR STOCK. Where stock of a subsidiary company was acquired with the stock of the parent company, the amount to be included in the consolidated invested capital in respect of the company acquired will be computed in the same manner as if the net tangible assets and the intangible assets had been acquired instead of the stock. If in accordance with such acquisition a paid-in surplus is claimed, such claim must be supported by substantially the same sort of evidence as is required in the case of a claim for paid-in surplus in respect of tangible property paid in by a stockholder to a corporation as a gift or at a value definitely

known or accurately ascertainable as of the date of payment clearly and substantially in excess of the cash or other consideration paid by the corporation therefor.[1]

[1] Reg. 45, Art. 868; T. D. 2901, modifying T. D. 2662. See also Reg. 45, Art. 837; T. B. R. 49, Treasury Bulletin 16-19-467.

INVESTED CAPITAL FOR PREWAR PERIOD. The invested capital of affiliated corporations for the prewar period will be computed on the same basis as the invested capital for the taxable year, except that where any one or more of the corporations included in the consolidation for the taxable year were in existence during the prewar period, but were not then affiliated, then the average consolidated invested capital for the prewar period will be the average invested capital of the corporations which were affiliated in the prewar period plus the aggregate of the average invested capital for each of the several corporations which were not affiliated during the prewar period.[1]

[1] Reg. 45, Art. 869. See p. 692 of the 1920 edition. Full recognition, however, must be given to the provisions of Section 330 of the statute, particularly the last paragraph thereof, and of articles 931-934, Reg. 45.

PREWAR NET INCOME OF AFFILIATED CORPORATIONS. The consolidated net income of affiliated corporations for the prewar period will be the average consolidated net income for the prewar years of such of the several corporations included in the consolidation for the taxable year as were affiliated during the prewar period plus the aggregate of the average net income for each of the corporations not affiliated during the prewar period which were in existence during all of the prewar period or during at least one full year within the prewar period. The net income of a subsidiary corporation organized during the prewar period by an existing corporation should also be included.[1]

[1] Reg. 45, Art. 802.

NATIONAL BANK STOCKHOLDERS' TRUSTEE ACCOUNTS. It is the custom of national banks to declare dividends which instead of being paid to stockholders are carried with their consent to a stockholders' liability account in the name of a

trustee. This account may be used for investment in deals not countenanced by the Comptroller of the Currency. Although such trustee account is a liability to the individual stockholders and, therefore, from a technical viewpoint, not a part of the invested capital of the bank, even though the bank include income from the reserve in its gross income, the stockholders constitute an "association" in affiliation with the national bank. The amount of the reserve is therefore to be included in consolidated invested capital.[1]

[1] A. R. M. 43, Treasury Bulletin 17-20-881, overruling O. D. 260, Treasury Bulletin 16-19-466. Of course as a practical matter the national bank simply includes such reserve in its own invested capital.

Balance Sheet. Every corporation is required to submit a balance sheet as of the first day of the taxable year and also a balance sheet as of the close of the taxable year. Balance sheets are required to be made in accordance with the books of the taxpayer and changes in respect of any items therein made pursuant to the regulations are to be explained in a separate statement attached to the balance sheet to which it relates.[1]

[1] Reg. 41, Art 54. As to the preparation of consolidated balance sheets, see p. 168 of the 1920 edition.

Returns. Every corporation not expressly exempt from tax and every personal service corporation must make a return regardless of the amount of its net income.[1] Corporations which have no taxable income for the year are required to fill out only Schedules A and B of Form 1120, which relate to the income tax, and the schedules in support thereof, and are not required to furnish the other information called for by this form.[2] Excess-profits tax returns are now a part of the income tax returns of corporations, and are governed by the same rules as to time, place and manner of filing.

[1] Reg. 45, Art. 621.
[2] Letter from Treasury Department dated March 24, 1919; W. T. S. 1919, ¶ 1016.

Returns in Special Cases. Where a corporation computes its war-profits credit upon the basis of the sum of (a)

the specific exemption and (b) an amount equal to 10% of the invested capital for the taxable year, the items on form 1120 which relate solely to the net income or to the invested capital for the prewar period need not be filled in.[1] Where a corporation enters on its return a war-profits and excess-profits tax equal to the amount of the maximum tax, the items on form 1120 which relate solely to the net income for the prewar period and the items which relate to the invested capital for the prewar period and for the taxable year need not be filled in. Likewise in the case of a foreign corporation the same items may be disregarded, except that all of schedule I on form 1120 should be filled in and balance sheets as of the beginning and the end of the taxable year for the entire business of the corporation both within and without the United States should be submitted. Corporations which have no taxable income for the year are required to fill out only schedules A and B and the schedules in support thereof on their (separate or consolidated) returns (Form 1120) and are not required to furnish the other information called for by these returns.[2] The Commissioner may at any time specifically call for all or any part of the information which is not so required to be entered on the return. In any case, however, where a claim is made for assessment by reference to representative corporations other than in the case of a foreign corporation, the corporation should fill out all items of the return so far as possible and submit a statement explaining why it is impracticable to fill out the entire return.[3]

[1] Telegram from Treasury Department dated April 10, 1919; W. T. S. 1919, ¶ 1022. Under the 1917 Law it was held that a return of information as to invested capital and net income for the prewar period would not be required if the taxpayer accepted the minimum percentage of 7% as a deduction.

[2] Letter from Treasury Department dated March 24, 1919; W. T. S. 1919, ¶ 1076.

[3] Reg. 45, Art. 962.

Time and Manner of Paying Tax. The war-profits and excess-profits taxes are to be paid at the same times and places, in the same manner, and subject to the same conditions, as

provided in the case of payments of income tax; that is the tax will be paid in installments on the dates specified with reference to the income tax.[1]

[1] Revenue Act of 1918, § 336. As to the time and manner of paying income taxes see Chapter 35.

Penalties. All the provisions of the income tax law not inapplicable, including the provisions relating to penalties, are made applicable to the filing of returns and payment of war-profits and excess-profits taxes.[1]

[1] Revenue Act of 1918, § 336.

Administrative Provisions. In general, the administrative provisions applicable to the income tax law are also applicable to the administration of the war-profits and excess-profits tax law.[1]

[1] Revenue Act of 1918, § 336.

CHAPTER 44.

THE CAPITAL STOCK TAX

[Page 716.]

ASSOCIATION DISTINGUISHED FROM TRUST. A full discussion of the distinction between a "trust" and an "association" will be found in another chapter.[1]

[1] See Chapter 10 of the 1920 edition, and the supplement thereto, page 139.

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Fair Average Value of Capital Stock. The fair average value of the capital stock for the purpose of determining the amount of the capital stock tax must not be confused with the market value of the shares of stock where it may be necessary to determine such value under other provisions of the revenue laws. The fair average value of the capital stock, the statutory basis of the tax, is not necessarily the book value or the value based on prices realized in current sales of shares of stock or even the value, determined by capitalization of earnings, although it may be more directly dependent upon the last. It should usually be capable of appraisal by officers of the corporation having a special knowledge of the affairs of the corporation and general knowledge of the line of business in which it is engaged. Provision is accordingly made in Exhibit C of Form 707 (Revised) for the tentative determination of the fair value of the capital stock by capitalizing the net earnings of the corporation on a percentage basis fixed by its officers as fairly representing the conditions obtaining in the trade and in the locality. But such fair value, except in the case of insurance companies, must not be set at a sum less than the reconstructed book value shown by Exhibit A, unless the corporation is materially affected by extraordinary conditions which support a lower valuatiton. In any such case a full explanation must accompany the return.[1]

[1] Reg. 50, Rev., Art. 14.

[Page 721.]

Foreign Corporations. A foreign corporation is carrying on or doing business in the United States if it maintains an agent or an office or warehouse in the United States, or, in the case of an insurance company, if it writes insurance policies here, or in any other way enters the United States for the purposes of its business. The purchase of supplies in the United States in the furtherance of continued efforts in the pursuit of profit or gain is carrying on or doing business in the United States.[1]

[1] Reg. 50, Rev., Art. 17.

[Page 723.]

Stock Insurance Companies. In the case of stock insurance companies the tax will be computed by deducting from the total book value of the assets the amount of the actual liabilities and legal reserves, unless the facts in the case indicate that the book value of the assets is substantially different from their fair market value, in which case it is permissible to make proper adjustment. In a case requiring such adjustment the market value of the shares of stock as shown by Exhibit B or the net earnings of the company as shown by Exhibit C in Form 707 (Revised) shall be considered, as well as the fair value of the assets.[1]

[1] Reg. 50, Rev., Art. 22.

[Page 725.]

Holding Companies. It seems that the following circumstances will indicate that a holding company is doing business: (a) the fact that each of several subsidiaries has a director who is also a director of the parent company; (b) the borrowing of money from outside sources to finance subsidiaries whether for the purpose of operation or extension of the subsidiaries' business, but not, however, the reinvestment of securities of subsidiaries which have matured; (c) the acquisition from time to time of subsidiaries.

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Carrying On or Doing Business. The words "carrying on or doing business" must be given their ordinary and natural sig-

nification. "Business" is a very comprehensive term and embraces whatever occupies the time, attention or labor of men for the purpose of livelihood or profit. In other words, business necessarily involves the idea of gain. The true basis of distinction is, in the first instance, between—

(*a*) A corporation organized for the purpose of doing business as above defined, and

(*b*) A corporation organized for the sole purpose of owning and holding property and distributing its avails; and, in the second instance, between—

(*c*) A corporation of class (a) which is continuing the body and substance of the business for which it was organized or is still active and maintaining its organization for the purpose of continued efforts in the pursuit of profit or gain, and

(*d*) A corporation which, although included in class (a), has substantially retired from the business for which it was organized and has reduced its activities to the mere ownership and holding of property, distributing its avails, and doing only the acts necessary to the maintenance of its corporate existence and the private management of its purely internal affairs.

The distinction in each case must depend upon the peculiar facts in the case. Corporations of class (a) will be presumed to be subject to the tax unless they submit proof, satisfactory to the Commissioner, that they are not actually carrying on or doing business. If a corporation claim exemption on the ground that it belongs to class (b), it will be required to file an excerpt from its charter setting forth its corporate powers together with a full and comprehensive statement showing the nature of the activities in which it is and has been actually engaged. If it claim exemption on the ground that it belongs to class (d), it will be required to furnish a copy of any amendment of its charter, resolution of its board of directors, or other evidence, satisfactory to the Commissioner, showing that it has reduced its activities to the mere ownership of property, receipt of its avails, and the doing of only what is necessary to the maintenance of its corporate existence.[1] A corporation organized for the purpose of, and actually engaged in, buying mineral or timber land or other real estate and holding it with

[1] Reg. 50, Rev., Art. 10.

a view to future sale at an advance is carrying on or doing business. A corporation organized for the purpose of owning and leasing real estate which has leased all of the property under its control is still engaged in doing business unless, under the terms of its lease, its activities have been reduced to the mere receipt and distribution of the avails of the leases at the actual cost of so doing. If it is still maintaining its organization for the purpose of continued effort in the pursuit of profit and gain it is doing business. A corporation owning or managing real estate which leases all of its property but under the terms of the lease is required to maintain or keep the property in repair is doing business. A so-called holding company which, under its charter, is authorized to and does, in addition to receiving and distributing the avails of the property or securities held by it, finance the operations of its subsidiaries, is engaged in doing business. A corporation organized for the purpose of taking over and holding securities, timber land, coal lands or other real estate, is held to be doing business, if it makes investments or reinvestments of its surplus income or funds in excess of an amount necessary to maintain its original investments.[2]

Holding companies as distinguished from parent corporations, and corporations all of whose property and business is operated by, or is in the hands of, a receiver or the Alien Property Custodian, are not doing business. A holding company is defined as one whose corporate powers are limited to the mere owning and holding of property and distribution of its avails, or one which, although incorporated for the purpose of doing business, has substantially retired from the business for which it was organized and has reduced its activities to the mere ownership and holding of property, distributing its avails, and doing only such acts as are necesary to the maintenance of its corporate existence and the private management of its purely internal affairs. A holding company, as above defined, will not be considered to be doing business by reason of the reinvestment of its surplus income or funds to the extent only of maintaining its original investments.[1]

[2] Reg. 50, Rev., Art. 11.
[1] Reg. 50, Rev., Art. 12.

[Page 729.]

Footnote 45.

The amount of business done is immaterial. (Associated Pipe Line Co. v. U. S., 258 Fed. 800.)

[Page 732.]

Exempt Corporations. Where a building and loan association has no other feature which renders it liable to tax, it will ordinarily not be subject to tax merely because (1) it has paid-up shares which are (a) preferred as to earnings and (b) have a definite rate of interest which may be higher than the rate of dividends paid on other stock, or (2) its balance sheets show that it is loaning considerable sums to non-members, or (3) it is a regular borrower of large sums of money which it uses for loans to members, the dues paid by members being entirely inadequate for the business transacted by it.[1]

[1] Reg. 50, Rev., Art. 27.

[Page 734.]

Tentative Returns. The filing of a tentative return will avoid the penalty for delinquent filing, but does not authorize the withholding of the tax. The regulations do not permit the filing of a tentative return to stay indefinitely the filing of a completed return and the collection of the tax due; therefore, a tentative return clearly marked "Tentative return" should be prepared in as complete a manner as possible, including, among other information, a basis for the computation of the tax—that is, an estimate by the officers of the corporation of the approximate fair value of the capital stock in order that an initial assessment may be made. When the completed return is filed, it should be clearly marked "Completed return," showing that a tentative return was filed. Such action will prevent duplicate assessments and ordinary penalties. In every case a statement should be attached to the tentative return, indicating the approximate date the complete return may be expected. Upon receipt of the completed return any adjustment necessary in the assessment of the correct tax due will be made.[1]

[1] Reg. 50, Rev., Art. 34.

[Page 734.]

Return By Corporation Claiming Exemption. Where the officers of a corporation are of the opinion that it is exempt from the tax as an exempt corporation not being engaged in business, Form 707 (Revised) should be filled out and filed with the collector, together with a comprehensive statement of the reasons for claiming exemption. In such case the fair value should be reported on page 1 of the form, but the tax not computed, notation "Exemption claimed" being made instead. If exemption has been allowed for the preceding taxable year and there has been no change in the status or conditions of the company then the first 14 lines of Form 707 (Revised) should be completed and a statement attached to the effect that exemption is claimed for the same reasons as for the previous year and that the same status and conditions of the company exist for the taxable period in question. In this way the records of the collectors' offices will be complete and corporations will avoid requests for the filing of returns and unnecessary correspondence. The determination of liability rests in the first instance with the Commissioner and without complete information it is impossible to make a decision.[1]

[1] Reg. 50, Rev., Art. 28.

CHAPTER 45.

THE STAMP TAX

[Page 738.]

Footnote 1.

Add:—For a historical discussion of stamp tax legislation in the United States see Edwards v. Wabash Ry. Co., 264 Fed. 610.

[Page 739.]

Stamps. Documentary stamps only must be used upon papers, documents and instruments subject to tax except as provided in the regulations relating to stamp taxes on issue and transfers of stock and sales of products for future delivery.[1] Ordinary postage stamps cannot be used for the payment of any internal revenue taxes.[2] Where documentary stamps are rendered useless by gumming or sticking together in transit or otherwise without the fault of the purcnaser, they may be exchanged by a collector for other stamps of exactly the same quantity and denomination.[3]

[1] Reg. 55, Rev., Art. 181.
[2] Reg. 55, Rev., Art. 183.
[3] Reg. 55, Rev., Art. 184.

[Page 749.]

BONDS GIVEN TO THE FEDERAL GOVERNMENT. Indemnity bonds filed with the Treasury Department to secure the United States against loss on account of (1) the issue of duplicates in lieu of, or in payment of, lost, stolen, or destroyed United States bonds or notes; (2) the issue of definitive bonds of the First Liberty Loan against full-paid interim certificates proved to have been lost, stolen, or destroyed; or (3) issue of duplicate disbursing officer's checks, other than in payment of "any pension, allowance, allotment, relief, or insurance," granted to soldiers, sailors, marines, or their dependents, by the United States, or interest checks, for checks proved to have been lost, destroyed, or never received, are subject to

stamp tax. Indemnity bonds given by soldiers, sailors, marines, or other persons entitled to insurance under the war-risk insurance act, for the protection of the United States against loss by reason of the issuance of duplicate checks for such insurance, are not subject to stamp tax.[1]

[1] Reg. 55, Rev., Art. 28.

[Page 750.]

CONTRACT TO ISSUE STOCK. It has been held that the "issue" of stock generally means the issue of the certificates.[1] But the word "issued" has been held in other connections to have no technical meaning and stock has been held to be "issued" even though no certificates therefor have been made out or delivered.[2]

[1] Edwards v. Wabash Ry. Co., 264 Fed. 610.

[2] Flour City Nat. Bank v. Shire, 88 (N. Y.) App. Div. 401, 84 N. Y. Supp. 810, affirmed 179 N. Y. 587, 72 N. E. 1141; Amer. Pig Iron Co. v. State Board, 56 N. J. L. 389, 29 Atl. 160. In the latter case the court said: "The word 'issued,' as used in this connection, has no technical meaning. 'To issue,' as defined by lexicographers, signifies to send out; to put in circulation. In a popular sense, a corporation engaged in organization is said to issue stock when it obtains subscriptions for it, and in the construction of tax laws words are to be interpreted in their popular sense."

[Page 751.]

ORIGINAL ISSUE. It has been stated by the court that the 1914 Stamp Tax Law is not a franchise tax or a corporation tax, but a stamp tax or document tax.[1]

[1] Malley v. Bowditch, 259 Fed. 809, approved in Edwards v. Wabash Ry. Co., 264 Fed. 610.

[Page 751.]

Footnote 76.

Add.—The case of Malley v. Bowditch, 259 Fed. 809, has been approved in Edwards v. Wabash Ry. Co., 264 Fed. 610.

[Page 751.]

Footnote 77.

Add:—The authority for the matter stated in this footnote is Reg. 40, Rev., Art. 33, and Cook on Corporations, Seventh Edition, par. 883.

[Page 752.]

Footnote 78.

Add:—The case of Edwards v. Wabash Ry. Co. has now been affirmed by the Circuit Court of Appeals (264 Fed. 610). In its opinion the Court said: "And the tax is laid, not on each stock certificate that is issued, but on each original issue of certificates. The language is used to indicate the first issuance of the stock, and this is emphasized by the use of the words, in the same connection 'whether on organization or reorganization.' When a corporation issued for the first time a certificate of the stock, that certificate is an original issue. The tax is placed on the *original* issue. The word 'original' is defined by Webster as 'pertaining to the origin or beginning; preceding all; first in order.'"

[Page 753.]

ISSUED BY ANY CORPORATION. A full discussion of the distinction between a "trust" and an "association" will be found in another chapter.[1]

[1] See Chapter 10 of the 1920 edition, and the supplement thereto, page 139.

[Page 753.]

Footnote 87.

Add:—The case of Malley v. Bowditch, 259 Fed. 809, has been approved in Edwards v. Wabash Ry. Co., 264 Fed. 610.

[Page 757.]

AFFIXING AND CANCELLATION OF STAMPS. It has been held by a State court under both the New York State tax on transfers of stock and the Federal Act on stock transfers that such laws are complied with if the requisite stamps be affixed and cancelled at the time the transfer is accomplished.[1]

[1] Smyth v. Pure Ice Co., N. Y. App. Div., Second Department, N. Y. Law Journal, Nov. 26, 1920; Phelps-Stokes Estates v. Nixon, 220 N. Y. 93; Waddle v. Cabana, 220 N. Y. 18; Bean v. Flint, 204 N. Y. 153.

[Page 759.]

TRUSTS. A full discussion of the distinction between a "trust" and an "association" will be found in another chapter.[1]

[1] See Chapter 10 of the 1920 edition, and the supplement thereto, page 139.

[Page 770.]

REALTY SOLD. In States where common-law dower still exists an instrument purporting to convey the inchoate right of dower of a wife or the consummate right of dower of a widow, prior to assignment of dower, is not subject to stamp tax; but an instrument conveying the estate acquired by a widow upon assignment of dower is subject to tax. Where by statute dower has been abolished and a different interest in the husband's real property conferred upon the wife in lieu thereof, the taxability of an instrument purporting to convey such an interest prior to its assignment will be determined by the nature of the wife's interest, and the statutes and decisions of the particular state in which the real estate is located must be consulted.[1] Conveyances to a trustee without valuable consideration or from a trustee to a *cestui que trust* without valuable consideration are not subject to tax.[2]

[1] Reg. 55, Rev., Art. 26.
[2] Reg. 55, Rev., Art. 105.

[Page 783.]

TICKETS SUBJECT TO TAX. Passage tickets sold or issued in the United States for passage by any vessel to a port or place in Newfoundland are subject to tax.[1]

[1] Reg. 55, Rev., Art. 119.

[Page 785.]

EXECUTED OR ACCEPTED IN FOREIGN COUNTRY. A power of attorney executed and mailed within the United States to a foreign point is subject to tax, but a power executed in a foreign country and mailed there to an agent in the United States is not subject to tax.[1]

[1] Reg. 55, Rev. Art. 142.

[Page 787.]

AUTHORITY TO SECRETARY OF CORPORATION TO TRANSFER STOCK. An instrument authorizing the secretary to transfer stock on the books of a corporation is not taxable as a power of attorney, but an instrument appointing an attorney in fact to transfer stock on the books of a corporation is taxable.[1]

[1] Reg. 55, Rev., Art. 138.

[Page 800.]

NOTES ISSUED BY GOVERNMENT. Promissory notes given to Federal land banks and joint-stock land banks when secured by first mortgages are exempt from stamp tax. Promissory notes issued by Federal land banks are exempt from stamp tax. Promissory notes issued by joint-stock land banks are subject to stamp tax.[1]

[1] Reg. 55, Rev., Art. 53.

[Page 800.]

Proxies. A proxy for voting at any election for officers of a corporation and authorizing the proxy to act in such capacity upon all questions or matters presented at a stockholders' meeting, is subject to tax of 10 cents only.[1]

[1] Reg. 55, Rev., Art. 126.

[Page 801.]

WHO MAY AFFIX STAMPS. Where proxies are sent out by a corporation to be executed and returned to the corporation or to the person named in the proxy, such proxies may be stamped after execution and delivery by the person receiving same as the agent of the person executing the proxy.[1]

[1] Reg. 55, Rev., Art. 128.

[Page 818.]

OTHER PENALTIES. Sections 13, 14 and 15 of the Act of June 13, 1898, as amended by the Act of March 2, 1901, have now been held by the Federal Court to be a part of the Revenue Act of 1918 and still in force so as to forbid the record and admission in evidence of unstamped promissory notes.[1]

[1] U. S. v. Masters, 264 Fed. 250.

[Page 821.]

VOIDING INSTRUMENTS FOR FAILURE TO STAMP. It has been held by a State court that a note which lacks the stamping required by the 1916 and 1918 Federal Laws is not "complete and regular on its face" and the purchaser of such a note is not a holder in due course.[1]

[1] Lutton v. Baker (Iowa), 174 N. W. 599.

[Page 825.]

Footnote 429.

Add:—The case of Malley v. Bowditch, 259 Fed. 809, has been approved in Edwards v. Wabash Ry. Co., 264 Fed. 610.

CHAPTER 47.

CONSTRUCTION OF TAXING STATUTES

[Page 839.]

Footnote 5.

Add:—LaBelle Iron Works v. U. S., decided June 28, 1920, Ct. of Cls. No. 34603; T. D. 3051, Treasury Bulletin 34-20-1158.

[Page 840.]

Footnote 7.

Add:—Columbia Water Co. v. Columbia Co., 172 U. S. 475; Mallard v. Lawrence, 16 How. 251.

[Page 842.]

Proceedings in Congress as Aid to Construction. The legislative history of a subsequent statute will not be considered as an aid to construction.[1]

[1] Penn Mut. Life Co. v. Lederer, U. S. Sup. Ct., April, 1920.

[Page 843.]

Footnote 30.

Add:—Woollcott v. Shubert, 217 N. Y. 212, 111 N. E. 829.

[Page 843.]

Footnote 31.

Add.—Caminetti v. U. S., 242 U. S. 470, 490.

[Page 844.]

Effect of Rulings and Practice of Treasury Department. The construction of the Treasury Department cannot repeal a statute.[1]

[1] Cryan v. Wardell, 263 Fed. 248.

[Page 844.]

Footnote 36.

Add:—Edwards v. Wabash Ry. Co., 264 Fed. 610; La Belle Iron Works v. U. S., decided June 28, 1920, Ct. Cls. No. 34603; T. D. 3051, Treasury Bulletin 34-20-1158.

[Page 844.]

Footnote 37.

Add:—Maryland Casualty Co. v. U. S., 251 U. S. 342.

[Page 845.]

Footnote 45.

Add:—Smietanka v. Zibell, U. S. Circ. Ct. of Appeals, 7th Circ., decided January, 1920; T. D. 3000, Treasury Bulletin 15-20-857.

[Page 845.]

Footnote 48.

Wabash Railway Co. v. Edwards, 264 Fed. 610.

[Page 847.]

Footnote 57.

Add:—Osgood v. Tax Commissioner (Mass.), 126 N. E. 371.

[Page 848.]

Footnote 62.

Wabash Railway Co. v. Edwards, 264 Fed. 610. See also New York Trust Co. v. Eisner, U. S. Dist. Ct., So. Dist. N Y., N. Y. Law Journal, March 4, 1920.

APPENDIX.

[Page 855.]

The provision of the 1909 Law authorizing corporations to deduct from gross income interest actually paid within the year to an amount "not exceeding the paid-up capital stock," is held to mean the paid-up capital stock at par value, and a corporation might not add a premium received on sale of its stock to enlarge such deduction. (Boston & M. R. R. v. U. S., 265 Fed. 578; U. S. v. N. Y., N. H. & H. R. R. Co., 265 Fed. 331); Sol. Op. 23, Treasury Bulletin 39-20-1217. Moneys paid by stockholders to a corporation in the nature of advances are not payments for capital stock. (Associated Pipe Line Co. v. U. S., 258 Fed. 800.)

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